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GLOBALIZATION OF THE SECURITIES MARKETS AND S. 646, THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 646

TO AMEND THE FEDERAL SECURITIES LAWS IN ORDER TO FACILITATE COOPERATION BETWEEN THE UNITED STATES AND FOREIGN COUNTRIES IN SECURITIES LAW ENFORCEMENT

JUNE 14, 15, 1989

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CONTENTS

WEDNESDAY, JUNE 14, 1989

Page
Opening statement of Senator Dodd 1
Opening statements of:
  Senator Heinz 20
  Senator Riegle 21
  Senator Shelby 22
  Senator Sasser 53
  Senator D'Amato 53
  Senator Sanford 54
  Senator Gramm 55
Senate bill S. 646 3

WITNESSES

Alan Greenspan, Chairman, Board of Governors, Federal Reserve System 23
  Prepared statement 28
John G. Heimann, vice chairman, Merrill Lynch Capital Markets, chairman, executive committee, Merrill Lynch Europe/Middle East, New York, NY 71
  Prepared statement 73
Robert D. Hormats, vice chairman, Goldman Sachs International, New York, NY 84
  Prepared statement 88
Alan S. MacDonald, group executive, North American Investment Bank, Citicorp 101
  Prepared statement 105

THURSDAY, JUNE 15, 1989

Opening statement of Senator Dodd 131
Opening statements of:
  Senator Heinz 133
  Senator Riegle 134
  Senator Pressler 136
  Senator D'Amato 136
    Prepared statement 137
  Senator Sasser 138
  Senator Sanford 139

WITNESSES

David S. Ruder, chairman, Securities and Exchange Commission 139
  Prepared statement 141
Stephen H. Axilrod, vice chairman, Nikko Securities Co. International, Inc., New York, NY 230
  Prepared statement 234
Lord Camoys, deputy chairman, Barclays de Zoete Wedd Holdings Ltd., London, England 254
John C. Hennessy, vice chairman and CEO-designate, CS First Boston, Inc 257
  Prepared statement 261

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Page
Report from the Congressional Research Service entitled, "Globalization of Securities Markets" 300

GLOBALIZATION OF THE SECURITIES MARKETS AND S. 646, THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989

WEDNESDAY, JUNE 14, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Securities,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Riegle, Sasser, Sanford, Shelby, Heinz, D'Amato, Pressler and Gramm.

OPENING STATEMENT OF SENATOR DODD

Senator Dodd. The subcommittee will come to order.

Let me welcome everyone this morning to our hearing on the globalization of the securities markets and S. 646, the International Securities Enforcement Cooperation Act of 1989.

The international securities markets have grown dramatically in recent years. Since 1980, in just the equity areas alone, foreign trading in U.S. stocks has grown more than 550 percent and U.S. trading in foreign stocks has increased more than 960 percent.

As Chairman Greenspan notes in his written testimony this morning, purchases and sales of foreign bonds by U.S. residents have increased ten-fold since 1980. In other areas, the numbers are staggering. As John Heimann points out in his testimony, last year alone, $10 trillion of securitized funds moved across national borders.

By every measure, the growth of international financial transactions has been extraordinary, and every expert from the private to the public sector tells us that the globalization trend is inevitable and unstoppable.

These hearings are, in my view, among the most important ones this subcommittee will hold this year. Too often, we in the Congress are in the position of simply reacting to problems or events, whether it's the FSLIC crisis, the 1987 market crash, or the most recent multi-billion dollar leveraged buyout.

Today and tomorrow, we will be trying to get ahead of the curve, so to speak. That is not to say that the international markets and the institutions that participate in those markets aren't ahead of us already in many respects, but the problems thus far have been manageable.

Today, we will ask our distinguished public and private sector witnesses just what the globalization of securities markets means for the soundness and efficiency of our market systems. Just how well do our markets work on a global level? Is there a need for greater harmonization or regulation? What is the degree of international coordination among the various regulators? In a global environment where a failure in one sector can quickly ripple around the world, what are we doing to contain problems? Is there a plan for financial crisis management on a global scale? If not, why not? If so, what is that plan?

We will also ask questions in another area. As we developed the data for these hearings, I was struck by the numbers showing the relative decline of American markets and American financial institutions and the rapid growth of our major competitors, especially Japan. Last year, the Tokyo Stock Exchange accounted for 44 percent of the world's equity capitalization, with a total market value of $3.8 trillion. The New York Stock Exchange equity capitalization was $2.7 trillion and London's International Stock Exchange was $700 billion. I am told that the Tokyo market may now account for more than 50 percent of the world's total equity capitalization.

In terms of capital, four of the five top securities firms are Japanese. Only one U.S. firm is in the top five, Shearson at number two. For 1987, the last year for which we have rankings, only one U.S. bank was in the top ten in terms of assets—Citicorp at number eight. The next U.S. banks were Chase at number 33, and BankAmerica at 38.

Of course, there are many reasons for these numbers, and the size of our markets and the size of our institutions should not be the only measure of our success. However, we simply cannot ignore these trends.

Our financial markets, our banks and our securities firms are simply too important to our national economy for us to slip into second place willingly.

We will ask our experts this morning and tomorrow the significance of these numbers and these trends.

Again, I want to thank our witnesses this morning, particularly Chairman Greenspan of the Federal Reserve Board, John Heimann, Bob Hormats and Alan MacDonald, for all being with us as we examine these issues.

[Copy of proposed bill follows:]

101st CONGRESS
1st Session

S. 646

To amend the Federal securities laws in order to facilitate cooperation between the United States and foreign countries in securities law enforcement.

IN THE SENATE OF THE UNITED STATES

March 17 (legislative day, January 3), 1989

Mr. Dodd (for himself and Mr. Heinz) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Federal securities laws in order to facilitate cooperation between the United States and foreign countries in securities law enforcement.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) Short Title.—This Act may be cited as the "International Securities Enforcement Cooperation Act of 1989".

(b) Table of Contents.—

Sec. 1. Short title; table of contents.
Sec. 2. Release of records by the Commission.
Sec. 3. Sanctions against broker or dealer, associated person, or persons seeking association.

Sec. 4. Definition of foreign financial regulatory authority.
Sec. 5. Sanctions against investment advisers or persons associated or seeking association with a registered investment adviser or investment company.
Sec. 6. Definitions of foreign securities authority and foreign financial regulatory authority.
Sec. 7. Reimbursement of expenses incurred in an investigation undertaken at the request of a foreign securities authority.

SEC. 2. RELEASE OF RECORDS BY THE COMMISSION.

Section 24 of the Securities Exchange Act of 1934 (15 U.S.C. 78x) is amended—

(a) in subsection (b) by striking "Nothing in this subsection shall authorize the Commission to withhold information from the Congress."; and

(b) by adding at the end thereof the following new subsection:

"(c) Notwithstanding any other provision of law, the Commission may, in its discretion and upon a showing that such information is needed, provide all 'records' (as defined in subsection (a)) and other information in its possession to such persons, both domestic and foreign, as the Commission by rule deems appropriate if the person receiving such records or information provides such assurances of confidentiality as the Commission deems appropriate.

"(d) Notwithstanding the provisions of Section 552 of title 5, United States Code, popularly referred to as the Freedom of Information Act, or of any other law, the Commission shall not be compelled to disclose records obtained from a foreign securities authority if the foreign securities authority has in good faith represented to the Commission that public disclosure of such records would be contrary to the laws applicable to that foreign securities authority.

"(e) Nothing in this section shall—

"(1) alter the Commission's responsibilities under the Right to Financial Privacy Act (12 U.S.C. 3401 et seq.), as limited by Section 21(h) of the Securities Exchange Act (15 U.S.C. 78u(h)), with respect to transfers of records covered by such statutes, or

"(2) authorize the Commission to withhold information from the Congress or prevent the Commission from complying with an order of a court of the United States in an action commenced by the United States or the Commission.".

SEC. 3. SANCTIONS AGAINST BROKER OR DEALER, ASSOCIATED PERSONS, OR PERSONS SEEKING ASSOCIATION.

(a) AUTHORITY OF THE COMMISSION TO SANCTION BROKERS AND DEALERS FOR FOREIGN VIOLATIONS.—Section 15(b) (15 U.S.C. 78o(b)) of the Securities Exchange Act of 1934 is amended—

(1) in paragraph (4)(B), by inserting after "misdemeanor" the following: "or has been convicted within ten years of a substantially equivalent crime by a foreign court of competent jurisdiction";

(2) in paragraph (4)(B)(i), by inserting after "burglary," the following: "any substantially equivalent activity however denominated by the laws of the relevant foreign government";

(3) in paragraph (4)(B)(ii)—

(A) by inserting after "transfer agent," the following: "foreign person performing a function substantially equivalent to any of the above,";

(B) by inserting after "(7 U.S.C. 1 et seq.)" the following: "or any substantially equivalent foreign statute or regulation";

(4) in paragraph (4)(B)(iii), by inserting after "securities," the following: "or substantially equivalent activity however denominated by the laws of the relevant foreign government,";

(5) in paragraph (4)(B)(iv), by inserting after "United States Code" the following: ", or a violation of a substantially equivalent foreign statute.";

(6) in paragraph (4)(C)—

(A) by inserting after "transfer agent," "foreign person performing a function substantially equivalent to any of the above,";

(B) by inserting after "Commodity Exchange Act" each time it appears, "or any substantially equivalent foreign statute or regulation"; and

(C) by inserting after "insurance company," "foreign entity substantially equivalent to any of the above,"; and

(7) by inserting after subparagraph (F) of paragraph 4 the following:

"(G) has been found by a foreign financial regulatory authority to have—

"(i) made or caused to be made in any application for registration or report required to be filed with a foreign financial regulatory authority, or in any proceeding before a foreign financial regulatory authority with respect to registration, any statement that was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to the foreign financial regulatory authority any material fact that is required to be stated therein;

"(ii) violated any foreign statute or regulation regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade;

"(iii) aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of any statutory provisions enacted by a foreign government, or rules or regulations thereunder, empowering a foreign financial regulatory authority regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade, or has been found, by a foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of such statutory provisions, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.".

(b) EXTENSION OF DEFINITION OF STATUTORY DISQUALIFICATION TO INCLUDE FOREIGN VIOLATIONS.—Section 3(a)(39) of such Act (15 U.S.C. 78c(a)(39)) is amended—

(1) in subparagraphs (A)—

(A) by inserting after "self-regulatory organization," the following: "foreign equivalent of a self-regulatory organization, foreign or international securities exchange,"; and

(B) by inserting after both "(7 U.S.C. 7)," and "(7 U.S.C. 21),", the following: "or any substantially equivalent foreign statute or regulation,";

(C) by inserting after "contract market", the following: "or foreign equivalent";

(2) in subparagraph (B)—

(A) by striking "Commission or other appropriate regulatory agency" and inserting "Commission, other appropriate regulatory agency, or foreign financial regulatory authority";

(B) by inserting after "government securities dealer," the first place it appears, the following: "or limiting his activities as a foreign person performing a function substantially equivalent to any of the above,";

(C) by inserting after "government securities dealer," the second place it appears, the following: ", or foreign person performing a function substantially equivalent to any of the above,";

(D) by striking the semicolon and inserting the following: ", or is subject to an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;".

(3) by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively;

(4) by inserting after subparagraph (C) the following:

"(D) by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;";

(5) in subparagraph (E) (as redesignated by paragraph (3) of this subsection) by striking "(A), (B), or (C)" and inserting "(A), (B), (C), or (D)".

(6) in subparagraph F (as redesignated) by striking "(D) or (E)" and inserting in lieu thereof "(D), (E), or (G)" and by inserting after "such paragraph (4)" the first place it appears the following: "or any other felony".

(c) CONFORMING AMENDMENTS.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended—

(1) in sections 15(b)(6), 15B(c)(2), 15B(c)(4), 15C(1)(A), 15C(c)(1)(c), 17A(c)(3)(A), and 17A(c)(3)(C), by striking "(A), (D), or (E)" and inserting "(A), (D), (E), or (G)"; and

(2) in section 15C(f)(2), by striking "or the rules or regulations under any such other provision" and inserting "the rules or regulations under any such other provision, or investigations pursuant to section 21(a)(2) of this title to assist a foreign securities authority.".

SEC. 4. DEFINITION OF FOREIGN FINANCIAL REGULATORY AUTHORITY.

Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is further amended by adding at the end thereof the following new paragraph:

"(51) The term 'foreign financial regulatory authority' means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate participation of its members in activities listed above.".

SEC. 5. SANCTIONS AGAINST INVESTMENT ADVISERS OR PERSONS ASSOCIATED OR SEEKING ASSOCIATION WITH A REGISTERED INVESTMENT ADVISER OR INVESTMENT COMPANY.

(a) INVESTMENT COMPANY ACT OF 1940.—Section 9(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–9(b)) is amended—

(1) by striking "or" at the end of paragraph (2);

(2) by striking the period at the end of paragraph (3) and inserting a semicolon; and by inserting after paragraph (3) the following:

"(4) has been found by a foreign financial regulatory authority to have—

"(A) made or caused to be made in any application for registration or report required to be filed with a foreign securities authority, or in any proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

"(B) violated any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade;

"(C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade;

"(5) within ten years has been convicted by a foreign court of competent jurisdiction of a crime, however, denominated by the laws of the relevant foreign government, that is substantially equivalent to an offense set forth in paragraph (1) of subsection (a); or

"(6) by reason of any misconduct, is temporarily or permanently enjoined by any foreign court of competent jurisdiction from acting in any of the capacities, set forth in paragraph (2) of subsection (a), or a substantially equivalent foreign capacity, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security.".

(b) INVESTMENT ADVISERS ACT OF 1940.—Section 203(e) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e)) is amended—

(1) in paragraph (2) by inserting after "misdemeanor" the following: "or has been convicted within ten years of a substantially equivalent crime by a foreign court of competent jurisdiction";

(2) in paragraph (2)(A), by inserting after "burglary," the following: "any substantially equivalent activity however denominated by the laws of the relevant foreign government,";

(3) in paragraphs (2)(B) and (3)—

(A) by inserting after "transfer agent" the following: "foreign person performing a function substantially equivalent to any of the above,"; and

(B) after "Commodity Exchange Act" each place it appears, the following: "or any substantially equivalent statute or regulation";

(4) in paragraph (2)(C), by inserting after "securities" the following: "or substantially equivalent activity however denominated by the laws of the relevant foreign government";

(5) in paragraph (2)(D) by inserting after "United States Code" the following: ", or a violation of a substantially equivalent foreign statute";

(6) in paragraph (3)—

(A) by inserting after "court of competent jurisdiction" the following: ", including any foreign court of competent jurisdiction,"; and

(B) by inserting after "insurance company," the following: "foreign entity substantially equivalent to any of the above,";

(7) in paragraph (5), by inserting after "this title," the following: "the Commodity Exchange Act,";

(8) by inserting after paragraph (6) the following new paragraph:

"(7) has been found by a foreign financial regulatory authority to have—

"(A) made or caused to be made in any application for registration or report required to be filed with a foreign securities authority, or in any proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

"(B) violated any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade;

"(C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade, or has been found, by the foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of statutory provisions, and rules and regulations promulgated thereunder, another person who commits such a violation, if such other person is subject to his supervision.".

(c) CONFORMING AMENDMENT.—Section 203(f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(f)) is amended by striking "paragraph (1), (4), or (5)" and inserting "paragraph (1), (4), (5), or (7)".

SEC. 6. DEFINITION OF FOREIGN SECURITIES AUTHORITY AND FOREIGN FINANCIAL REGULATORY AUTHORITY.

(a) INVESTMENT COMPANY ACT OF 1940.—Section 2(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80a–2(a)) is amended by inserting after paragraph (48) the following:

"(49) 'Foreign securities authority' means any foreign government or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

"(50) 'Foreign financial regulatory authority' means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate the participation of its members in activities listed above.".

(b) INVESTMENT ADVISERS ACT OF 1940.--Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)) is amended by inserting after paragraph (22) the following:

"(23) 'Foreign securities authority' means any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

"(24) 'Foreign financial regulatory authority' means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate participation of its members in activities listed above.".

SEC. 7. REIMBURSEMENT OF EXPENSES INCURRED IN AN INVESTIGATION UNDERTAKEN AT THE REQUEST OF A FOREIGN SECURITIES AUTHORITY.

Section 4 of the Securities Exchange Act of 1934 (15 U.S.C. 78d(c)) is amended by adding at the end thereof the following new subsection:

"(f) Notwithstanding any other provision of law, the Commission may accept payment and reimbursement, in cash or in kind, from a foreign securities authority, or made on behalf of such authority, for necessary expenses incurred by the Commission, its members, and employees in carrying out any investigation pursuant to section 21(a)(2) of this title or in providing any other assistance to a foreign securities authority. Any payment or reimbursement accepted shall be considered a reimbursement to the appropriated funds of the Commission.".

Senator DODD. Before we turn to you, Chairman Greenspan, I'd like to turn to my ranking minority member, Senator Heinz of Pennsylvania.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, first, I commend you on holding these hearings on the globalization of our securities markets and indeed you have invited both today and tomorrow an extremely impressive array of witnesses. We are all, of course, delighted to welcome Alan Greenspan back to this committee.

I might just observe that today and tomorrow this subcommittee looks beyond our border and beyond the present to examine internationalization and the future of world capital markets. The globalization process has indeed taken place at a rapid pace and the changes continue to occur daily.

As we study the recent events of the past, we hope to develop a far clearer vision of the future. As securities trade around the four corners of the globe, I'm most interested in what I would call the four C's—competitiveness, capital formation, coordination, and crime. I would like to know how we can enhance the first three and eradicate the fourth.

The internationalization of securities markets is evolving right now and we can either act affirmatively to enhance the U.S. position in the global village or we can sit back and watch the world go by. I am concerned about the continued ability of U.S. institutions and markets to remain atop the competitive roost and in fact by certain measures we've already lost our leading edge in some areas.

With respect to capital formation, we should seek to ensure that artificial and inefficient impediments to the free flow of capital, which are the lifeblood of economic growth and development,— are eliminated. Our goal should be to ensure effective market access for all market participants.

Coordination among our host of regulators, and we have more than a few, is essential to speaking to the world community with a single voice and with a unified policy. It would seem to me impossible for us to achieve our negotiating objectives unless there is one negotiator with one set of objectives.

So I would invite comment today on an idea that I've been thinking about and developing, which would be to create an interagency task force which would be responsible for coordinating international capital market matters which are beyond the expertise or the authority of any one agency. And I would also appreciate comments on how that might best be organized.

An additional reason for that thinking is that coordination on the international level is also necessary so that we can achieve some progress on standards, by which I mean harmonized disclosure, accounting and regulatory standards which would have as their benefit promoting and ensuring more transparent, more open, and more sound global markets.

At the same time, and fourthly, I believe we have to ensure the integrity of the world capital markets. Too often, we read about securities fraud that's occurring in foreign markets and across borders, but just because it is domiciled elsewhere does not mean it is not affecting us or even costing us. So we've got to stamp it out. The International Securities Enforcement Cooperation Act is a first step in this very important direction.

And in discussing these issues, Mr. Chairman, I agree with you I think we are fortunate to have a truly esteemed group of witnesses today and tomorrow. These are individuals who are truly in the forefront of the international securities frontier and I do look forward to hearing their worldly views.

Senator DODD. Thank you very much, Senator Heinz.

The Chairman of the Banking Committee, Senator Riegle.

Senator RIEGLE. Thank you, Senator Dodd.

Senator HEINZ. Senator Dodd, as you know, I am cochairing another hearing this morning and I will be in and out and right now I'm going to be out, so I want to apologize to you.

Senator DODD. You will be missed.

Senator HEINZ. Well, I thank you for your understanding.

Senator DODD. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

Senator Heinz and I both, as members of the Finance Committee, have activities there this morning on the Super 301 trade provision and we have Carla Hills testifying so we will have to go back and forth in the course of the morning.

But I want to say to you, Chairman Dodd, and also to Senator Heinz, how strongly I support the very vigorous steps that the subcommittee is taking and I particularly appreciated your strong statement this morning, Senator Dodd, to move things forward.

I had the chance in the previous Congress to hold this subcommittee chairmanship, along with Senator Heinz, and we had begun to do several things that are not quite at the finish line but hopefully can reach the finish line in this Congress.

I want to emphasize specifically my very strong support for S. 646, the International Securities Enforcement Cooperation Act of 1989. Whether you decide to move this legislation separately or as part of a package, I look forward to marking it up at the full committee level when you feel you are ready to go.

I think this legislation is essentially noncontroversial, at least it was last year when we examined it in the Securities Subcommittee, as were other pieces of securities legislation which I look forward to working with you and dealing with.

Broadening out just the framework for a moment, this hearing this morning I think is particularly pertinent to beginning an examination of our overall international competitiveness in all sectors and very particularly in the area of financial services.

In looking at globalization of the securities markets it's clear that our competitive position vis-a-vis the Japanese in the financial services market is slipping. Tokyo has exceeded the New York Stock Exchange in terms of trading volume. In 1988, the Tokyo Stock Exchange accounted for 44 percent of the world's equity capitalization and in 1987, of the top ten banks in terms of assets, there was only one U.S. bank, Citicorp, which ranked number eight. So clearly there is a very massive reordering of strength and size going on in the global financial system and it's something that we must examine and understand I think very thoroughly.

We will also be examining this issue at the full committee level on July 13th when Gerald Corrigan of the New York Fed and John Reed of Citicorp, Felix Rohatyn and Jay Light of the Harvard Business School will be testifying on the subject of the financial services industry in the 1990s. So that will provide a very important frame of reference I think in which to look at some of these questions.

I also want to take note of the witness list today and the fact that we have Alan Greenspan leading off today, who I know will have very important testimony for us.

Senator DODD. Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement that I'd ask be made part of the record in order so that we can move the hearing. Most of us came here, including the people in the audience, to hear the chairman and that would move the hearing on.

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, first may I commend you for scheduling these hearings and for inviting so distinguished a panel of witnesses. This is a excellent opportunity to explore many important issues.

I have looked over the testimony and am not surprised to find a thorough understanding of the changes that have created a globle marketplace. Today, I hope we can focus on how we, the Congress, need to respond in order to ensure continued progress.

The internationalization of the securities markets is a stunning example of the increasing interaction among foreign markets for all industries. A fire of innovation, fueled by rapid improvements in telecommunications and information technology, has blazed a truly global marketplace, in which national sovereignty is of secondary importance and the efficient utilization of capital, goods, and services is primary. Necessarily, this increased interdependence has sparked change on the legislative and regulatory front as well.

Most impressive is the action of the European Community. Having doubled in size since its original membership in 1957, the EC is well on its way toward accomplishing the mission it set out in the Treaty of Rome. By the end of 1992, substantial progress will have been made toward creating a unified European marketplace. Thus far, European nations have demonstrated a remarkable willingness to subordinate parochial interests in anticipation of gaining offsetting benefits, including an enhanced competitive position relative to the United States and Japan. Indeed, this unprecedented spirit of cooperation is a direct result of increasing competitive pressure from non-EC competitors, including the United States but particularly from Japan.

Trading partners with the EC stand to gain much from an integrated marketplace, in which universal minimum standards will make it possible to target 330 million consumers. The evolution toward a true EC, however, places substantial leverage in the hands of the Europeans. For access to the world's single largest free market, the Europeans have every right to demand reciprocal treatment with its trading partners.

To the United States, the EC currently represents the market for 25% of our exports, with vast potential for growth. It is important that we be willing to coordinate internal regulation and external policy to facilitate increased trade between the United States and the EC.

For our part, 240 million U.S. citizens give us substantial leverage. It is important that we aggressively negotiate with others particularly the Japanese, for increased access to foreign markets.

In this era of budget deficits, we have been fortunate to have the Japanese as willing investors. However, Japanese investment has not been limited to financing the Federal deficit but has extended into substantial holdings in virtually every sector of American business.

We have benefited in many ways from the Japanese presence; Japanese direct investment has increased industrial production capacity, introduced new technology and management expertise, as well as provided thousands of jobs. For its part, however, the United States has granted the Japanese liberal access to 240 million consumers at a time when personal consumption is up and personal savings rates down. The Japanese have benefited handsomely from the openness of United States markets. Yet foreigners do not have similar access to the Japanese market.

Our trade deficit with Japan is old news; I am hopeful that negotiations resulting from the potential use of the super 301 provision of the trade bill will make progress toward opening the Japanese market.

The Tokyo Stock Exchange has outstripped the United States in both volume traded and market value. While several factors diminish the relevance of this growth, the fact remains that Tokyo's rapidly increasing dominance represents competitive pressure that we must take seriously.

Moreover, Boone Pickens recent experience with his purchase of Koito manufacturing stock indicates that the scope of the USTR's discussions must be broad enough to include issues of corporate governance.

In this post war period, the United States has enjoyed global economic dominance. We take satisfaction in chauvinisticly stating that the U.S. capital markets are the most efficient and the most sophisticated in the world. However, there is danger in complacency.

At one time, the United States was so far ahead that other nations had little choice but to follow. But the competitive pressures posed by our trading partners in the Pacific Rim and the EC's plans for 1992 must serve as a catalyst for global cooperation. We must acknowledge our increasing interdependence and work to update the framework of regulations, legislation, and traditions that currently hinder market driven interaction.

All of today's witnesses can and must play an important role in that process. From the vantages of your respective positions, you can assist the United States in meeting the challenge of globle competition by telling those of us the legislative and the executive branches what you need to compete. I look forward to your comments.

Mr. Chairman, I have other commitments. I regret that I cannot stay the entire time but I request the right to submit some questions to the witnesses for answer in writing.

Thank you, Mr. Chairman.

Senator DODD. Thank you very much, Senator Shelby.

Mr. Chairman, we welcome you here this morning. We want to thank you for taking the time to be with us. We sent you a rather lengthy letter outlining an awful lot of questions, and you responded with lengthy testimony. Obviously, all of that will be included in the record and, again, we are anxious to hear your comments.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Mr. Chairman, I should say, before thanking you for your invitation, that when you get lengthy answers to questions, it merely indicates a degree of non-knowledge that we have on an innumerable number of subjects and we're required to fill out the spaces with words. I trust that in the year or two ahead that the accumulation of knowledge that we will be able to pick up will multiply many-fold because what we don't know about this subject regrettably is larger than I would like to see.

In any event, a key factor behind the trends in international trade and securities transactions to which you and your colleagues have alluded is a process that I have described elsewhere as the downsizing of economic output. The creation of economic value has shifted increasingly toward conceptual and intangible values with decidedly less reliance on physical values.

A half-century ago, for example, our radios and calculators were bulky. Today, owing to modern electronics, they are tiny and light and capable of performing many more functions. Thin fiber optics are replacing vast tonnages of copper and with higher fidelity in transmission. Financial transactions, historically buttressed with reams of paper, are being progressively reduced to electronic charges.

As a consequence, the considerable increase in the economic well-being of most nations in recent decades has come about without much change in the bulk or weight of the gross national product. In part, this downsizing has reflected the economic need to conserve increasingly precious space. Also, it has been a response to the need to reduce the costs of moving goods and services to their most highly valued use, thereby conserving on energy, labor and other valuable resources.

Further contributing to this process have been quantum advances in technology spurred by economic forces. In recent years, the explosive growth in information gathering and processing techniques has greatly extended our analytical capabilities of substituting ideas for physical volume. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the 21st century and beyond. The purpose of production of economic value will not change. It serves human needs and values. But the form of output will be increasingly less tangible.

Relevant to this morning's topic, downsizing is having a profound impact on international trade and finance. Obviously, the less the bulk and the lower the weight, the easier it is to move goods. On a global basis, the real value of trade has grown at a 5 percent annual rate over the past two decades, significantly outstripping the growth in world domestic demand.

Clearly, as cross-border trade grows, gross surpluses and deficits on current account similarly can be expected to grow. That is, owing to the forces that are acting to boost the share of output going to trade, net cross-border financial claims relative to GNP can be expected to rise.

Moreover, new technology, especially computer and telecommunications technology, is boosting gross financial transactions at an even faster pace than the net transactions required to finance current account deficits.

Rapidly expanding data processing and virtually instantaneous information transmission capacity are facilitating in ways that were not feasible in earlier times the development of a broad spectrum of complex financial instruments which can be tailored to the hedging, funding and investment needs of a growing array of market participants.

Some of this has involved an unbundling of financial risks to meet the increasingly specialized risk-avoidance requirements of market participants. Exchange rate and interest rate swaps together with financial futures and options have become important means by which currency and interest rate risks get shifted to those most willing to take it on.

The proliferation of financial instruments, in turn, implies an increasing number of arbitrage opportunities, which tend to further boost gross financial transactions volume in relation to output.

Portfolio considerations also are playing an important role in the globalization of securities markets. As the welfare of people in the United States and abroad becomes more dependent on the performance of external economies and exchange market developments, it is natural for both individual investors and institutions which directly or indirectly manage the assets of individuals to acquire or raise the weight of foreign securities in investment portfolios. Such diversification provides investors a means of protecting against depreciation of the local currency on foreign exchange markets and domestic economic disturbances affecting asset values on local markets. Clearly, as international trade continues to expand more rapidly than global output and domestic economies become even more closely linked to those abroad, the objective of diversifying international securities portfolios will become increasingly important. Moreover, since the U.S. dollar is still the key international currency, such diversification has been and may continue to be disproportionately into dollars.

In summary, therefore, it would seem reasonable to assume that cross-border trading in securities will continue to expand rapidly for the foreseeable future. This implies that investors will wish to be able to adjust their holdings of foreign securities during times that coincide with their regular domestic trading hours. As a consequence, we can expect to see the move to around-the-clock trading extended to more securities.

As international securities trading has surged, growing more rapidly than trade and output, demands for clearing services across a wide range of financial instruments have soared, placing pressures on clearing and settlement systems. Some of these pressures arise from the greater interdependence among clearing and settlement systems. Investors today engage in a complex chain of financial transactions, often involving positions in both national and international markets, and difficulties in the clearing and settlement process in one of these markets can affect the ability to discharge obligations in others. We got a sense of such clearing and settlement problems in October of 1987 when the options clearing system was weakened by large losses in the options market and other difficulties emerged from inadequate coordination of "pays and collects" in the futures markets. A deficient clearing system in Hong Kong not only contributed to paralysis in that marketplace but cast a cloud over other markets as well.

Another important dimension to securities market risk resulting from growing internationalization is the emergence of large, multinational securities firms that increasingly act as underwriters, dealers and brokers in securities markets around the globe. A loss by one or more of these firms could impair that firm's functioning in other markets, thereby potentially transmitting a disturbance to those other markets.

If risks associated with cross-market and cross-border securities activities are to be contained, then it is critical that large investment firms have sound internal risk monitoring and control procedures in place. Moreover, there is no substitute for strong capital positions to act as buffers for losses.

Both the private and public sectors have important roles to play in the coordination of securities markets policies. Among the areas needing attention are capital of dealers and underwriters, clearing, settlement and payment systems, circuit-breakers, disclosure to investors, and accounting standards followed by securities issuers and intermediaries. In addition, coordination of insider trading rules and enforcement of securities market laws are issues of significance in the area of securities market regulation and oversight. To an important degree, more standardization in areas such as clearing and settlement and capital standards hold the promise of enhancing efficiency while at the same time strengthening market structures. Moreover, coordination of policies in these areas will act to reduce the scope of so-called regulatory arbitrage—that is, artificial reasons for investors or securities houses to favor one national market over others.

At the present time, a considerable amount of effort is being expended to coordinate within and across borders in these various areas. In some cases, this involves regulatory authorities. In some other cases, it involves the private sector. And in still others, it involves a combination of both. For example, there are a number of bilateral discussions between the SEC and securities market regulators in other countries on issues relating to the exchange of information and enforcement of securities market laws. Also, central banks have, within the context of their responsibilities, for national payment systems, been addressing risks associated with securities clearing and settlement and are working to coordinate policies on payment system netting arrangements.

It is important to realize that the contributions the private and public sectors can make differ depending on the issue. On matters such as clearing and settlement, the private sector has much to offer given its expertise and considerable self-interest in developing a sound global securities clearing and settlement system. Other areas, such as insider trading and enforcement, clearly require coordination among regulators.

At the present time, it appears that progress is being made in key areas needing attention. Given the diversity of traditional national standards, it may well take longer to reach agreements than we are accustomed to in our domestic financial system. It is also likely that as these coordination efforts get further along necessary legislative changes will become more evident.

In closing, Mr. Chairman, the stability of our financial markets must, of course, at root, rest on the performance of the world economy. Thus, at the very top of our consideration in maintaining a sound financial structure is the pursuit of sound economic policies both domestically and, to the extent relevant, on a coordinated international basis. At the same time, we must seek to strengthen that financial structure through appropriate market reforms, recognizing that even a system with formidable safeguards will be unable to insure against a disruption resulting from a massive speculative imbalance. Through the cooperative efforts of the private and public sectors, we can go a considerable distance in improving the safety and soundness of our financial market systems, but we cannot realistically expect to eliminate all risks to these systems.

Thank you.

[A summary and complete prepared statement of Alan Greenspan follows:]

SUMMARY OF TESTIMONY BY
ALAN GREENSPAN, CHAIRMAN
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman and other members of the Subcommittee on Securities of the Senate Banking Committee, I am pleased to appear today to discuss the internationalization of securities markets.

International transactions in securities have soared from levels earlier in this decade. This is true both of foreign purchases and sales of U.S. securities and, to a somewhat lesser degree, U.S. transactions in foreign securities.

Behind these trends in international trade and securities transactions is a process that I have described elsewhere as the "downsizing of economic output." The creation of economic value has shifted increasingly toward conceptual and intangible values with decidedly less reliance on physical volumes. A half century ago, for example, our radios and calculators were bulky. Today, owing to modern electronics, they are tiny and light and capable of performing more functions. Thin fiber optics are replacing vast tonnages of copper and with higher fidelity in transmission. Financial transactions historically buttressed with reams of paper are being progressively reduced to electronic charges.

The considerable increase in the economic well-being of most nations in recent decades has come about without much change in the bulk or weight of the gross national product.

In part, this downsizing has reflected the economic need to conserve increasingly precious space. Also, it has been a response to the need to reduce the costs of moving goods and services to their most highly valued use -- thereby conserving on energy, labor and other valuable resources. Further contributing to this process have been quantum advances in technology, spurred by economic forces. In recent years, the explosive growth in information gathering and processing techniques has greatly extended our analytical capabilities of substituting ideas for physical volume. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the twenty-first century and beyond. The purpose of production of economic value will not change. It serves human needs and values. But the form of output will be increasingly less tangible.

Downsizing is having a profound impact on international trade. Obviously, the less the bulk, and the lower the weight, the easier it is to move goods. On a global basis, the real value of trade has grown at a 5 percent annual rate over the past two decades, significantly outstripping the growth in world domestic demand.

Clearly, as cross-border trade grows, gross surpluses and deficits on current account similarly can be expected to grow. That is, owing to the forces that are acting to boost the share of output going to trade, net cross-border financial claims relative to GNP can be expected to rise.

Moreover, new technology -- especially computer and telecommunications technology -- is boosting gross financial transactions at an ever faster pace than the net transactions required to finance current account deficits. Rapidly expanding data processing and virtually instantaneous information transmission capacity are facilitating in ways that were not feasible in earlier times the development of a broad spectrum of complex financial instruments which can be tailored to the hedging, funding and investment needs of a growing array of market participants. Some of this has involved an unbundling of financial risk to meet the increasingly specialized risk avoidance requirements of market participants. Exchange rate and interest rate swaps together with financial futures and options have become important means by which currency and interest rate risks get shifted to those most willing to take it on. The proliferation of financial instruments in turn implies an increasing number of arbitrage opportunities, which tend to further boost gross financial transactions volume in relation to output.

Portfolio considerations also are playing an important role in the globalization of securities markets. As the welfare of people in the United States and abroad becomes more dependent on the performance of external economies and exchange market developments, it is natural for both individual investors, and institutions, who directly or indirectly manage the assets of individuals, to acquire or raise the weight of foreign securities in investment portfolios. Such diversification provides investors a means of protecting against depreciation of the local currency on foreign exchange markets and domestic economic disturbances affecting asset values on local markets. Clearly, as international trade continues to expand more rapidly than global output and domestic economies become even more closely linked to those abroad, the objective of diversifying international securities portfolios will become increasingly important. Moreover, since the U.S. dollar is still the key international currency, such diversification has been and may continue to be disproportionately into the dollar.

In summary, therefore, it would seem reasonable to assume that cross-border trading in securities will continue to expand rapidly for the foreseeable future. This implies that investors will wish to be able to adjust their holdings of foreign securities during times that coincide with their regular domestic trading hours. As a consequence, we can expect to see the move to around-the-clock trading extending to more securities.

As international securities trading has surged -- growing more rapidly than trade and output -- demands for clearing services across a wide range of financial instruments have soared, placing pressures on clearing and settlement systems. Some of these pressures arise from the greater interdependence among clearing and settlement systems. Investors today engage in a complex chain of financial transactions, often involving positions in both national and international markets, and difficulties in the clearing and settlement process in one of these markets can affect their ability to discharge obligations in others. We got a sense of such clearing and settlement problems in October 1987 when the options clearing system was weakened by large losses in the options market, and other difficulties emerged from inadequate coordination of "pays and collects" in the futures markets. A deficient clearing system in Hong Kong not only contributed to paralysis in that marketplace but cast a cloud over other markets as well.

Another important dimension to securities market risk resulting from growing internationalization is the emergence of large multinational securities firms that increasingly act as underwriters, dealers and brokers in securities markets around the globe. A loss by one or more of these firms could impair that firm's functioning in other markets, thereby potentially transmitting a disturbance to those other markets. If risks associated with cross-market and cross-border securities activities are to be contained, then it is critical that large investment firms have sound internal risk monitoring and control procedures in place. Moreover, there is no substitute for strong capital positions to act as a buffer for losses.

Both the private and public sectors have important roles to play in the coordination of securities market policies. Among the areas needing attention are capital of dealers and underwriters, clearing, settlement and payment systems, circuit breakers, disclosure to investors, and accounting standards followed by securities issuers and intermediaries. In addition, coordination of insider trading rules and enforcement of securities market laws are issues of significance in the area of securities market regulation and oversight. To an important degree, more standardization in areas such as clearing and settlement and capital standards holds the promise of enhancing efficiency while at the same time strengthening market structures. Moreover, coordination of policies in these areas will act to reduce the scope for so-called regulatory arbitrage --

that is, artificial reasons for investors or securities houses to favor one national market over others.

At the present time, a considerable amount of effort is being expended to coordinate within and across borders in these various areas. In some cases, this involves regulatory authorities; in some other cases, it involves the private sector; and in still others, it involves a combination of both. For example, there are a number of bilateral discussions between the SEC and securities market regulators in other countries on issues relating to the exchange of information and enforcement of securities market laws. Also, central banks have, within the context of their responsibilities for national payment systems, been addressing risks associated with securities clearing and settlement and are working to coordinate policies on payment system netting arrangements.

It is important to realize that the contributions that the private and public sectors can make differ, depending on the issue. On matters such as clearing and settlement, the private sector has much to offer given its expertise and considerable self-interest in developing a sound global securities clearing and settlement system. Other areas, such as insider trading and enforcement, clearly require coordination among regulators.

At the present time, it appears that progress is being made in key areas needing attention. Given the diversity of traditional national standards, it may well take longer to reach agreements than we are accustomed to in our domestic financial system. It is also likely that as these coordination efforts get further along, necessary legislative changes will become more evident.

In closing, the stability of our financial markets must, of course, at root, rest on the performance of the world economy. Thus, at the very top of our consideration in maintaining a sound financial structure is the pursuit of sound economic policies, both domestically, and to the extent relevant, on a coordinated international basis. At the same time, we must seek to strengthen that financial structure through appropriate market reforms, recognizing that even a system with formidable safeguards will be unable to insure against a disruption resulting from a massive speculative imbalance. Through the cooperative efforts of the private and public sectors, we can go a considerable distance in improving the safety and soundness of our financial market systems but we cannot realistically expect to eliminate all risks to these systems.

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Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Securities

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

June 14, 1989

Mr. Chairman and other members of the Subcommittee on Securities of the Senate Banking Committee, I am pleased to appear today to discuss the internationalization of securities markets. This subcommittee is to be commended for holding timely hearings on this important matter. Our markets and financial system are evolving at a brisk clip, in ways that were not fully envisioned only a few short years ago.

These developments hold a good deal of promise for the diversity of financial markets and instruments available to our investors. At the same time, they are enhancing the avenues of credit available to borrowers and the convenience and efficiency of financial services. However, these changes also are adding immensely to the complexity of our financial system and accordingly are posing new risks. With the memory of October 1987 still fresh in our minds, it is important that we stand back and review this process -- not only to take stock of what has happened but to understand better the economic causes of securities market globalization and to identify potential accompanying risks and ways to limit such risks. We also must be mindful that our domestic financial institutions have much to contribute to this process -- and the considerable economic benefits that it produces -- and we must seek to ensure that their competitive position is not inappropriately hindered.

In my remarks today, I would like to put trends in global securities market developments in some perspective, and to draw implications for financial risks. I shall touch on the efforts underway to coordinate policies internationally and the question of legislation. In this way, I hope to address those issues suggested in your letter of invitation that seem to be most relevant to the Federal Reserve's concerns.

Recent Trends

International transactions in securities have soared from levels earlier in this decade. This is true both of foreign purchases and sales of U.S. securities and, to a somewhat lesser degree, U.S. transactions in foreign securities. Transactions volume has been most dramatic in foreign purchases and sales of U.S. Treasury notes and bonds, which surpassed $3 trillion on a gross basis last year -- from $100 to 200 billion earlier in the decade. Foreign purchases and sales of U.S. corporate stocks and bonds also have been running dramatically above levels earlier in the decade, although they are off from peak levels of a couple years ago.

Similarly, U.S. residents have become much more active transactors in foreign bonds and stocks. Purchases and sales of foreign bonds by U.S. residents exceeded $400 billion, gross, last year -- up about ten-fold from the beginning of the decade. Meanwhile, U.S. transactions in foreign stocks recently have climbed into the $200 billion annual area on a gross basis -- after some retrenchment in the wake of the October 1987 collapse -- which also is up about ten-fold from the early part of this decade.

Clearly, this surge in cross-border financial transactions has accompanied a large advance in cross-border trade of goods and services. In the 1980s, growth of world output devoted to trade has continued to surpass growth of total output, although by a smaller margin than in the 1970s. Thus, the share of output going to trade has continued to rise. For the United States, the import share of our final purchases has moved higher in the 1980s, but there has been no discernable improvement in the export share of our output during this period of large external deficits.

In financial markets, securities and open market paper have tended to play a more important role in the financing of such international transactions in recent years, and net securities purchases have represented the largest source of capital inflow into the United States to finance our large external deficits. Investors have become more familiar with foreign securities issuers through the greater availability of foreign products in local markets, and through better information on foreign issuers made possible by vast improvements in information, aided by the revolution in electronic information processing and telecommunications. Moreover, the expansion of securities firms and banks into foreign markets, including their research function, adds to the information available to home country investors about foreign investment opportunities.

At the same time, issuers, seeking to minimize their funding costs, have increasingly over time tested external capital markets, most visibly the Euro-market. Furthermore, the growing sophistication of currency and interest rate swap markets has enhanced this process by enabling borrowers to issue instruments in fixed or floating form in the currency most desired by investors and to swap into the currency or form preferred by the borrower.

An increasing array of securities -- most notably government bonds and corporate stocks -- is being traded in secondary markets outside the traditional market of the issuer. Many of these securities are being traded at some point on the globe virtually around the clock, alongside foreign exchange, and this has been a factor behind the surge in transactions volume already noted. In many cases, financial futures and options contracts can be traded during these same hours, which facilitates a shifting of risk and an enhancement of market liquidity.

Underlying Economic Forces

Behind these trends in international trade and securities transactions is a process that I have described elsewhere as the "downsizing of economic output." The creation of economic value has shifted increasingly toward conceptual and intangible values with decidedly less reliance on physical volumes. A half century ago, for example, our radios and calculators were bulky. Today, owing to modern electronics, they are tiny and light and capable of performing more functions. Thin fiber optics are replacing vast tonnages of copper and with higher fidelity in transmission. Financial transactions historically buttressed with reams of paper are being progressively reduced to electronic charges. Such advances not only reduce the amount of human effort required in making and completing financial transactions but facilitate more accuracy and promptness in execution.

The considerable increase in the economic well-being of most nations in recent decades has come about without much change in the bulk or weight of the gross national product. In fact, if all the weight of materials -- the tons of grain, cotton, ore, coal, steel, cement, and so forth -- we produce were added up, their aggregate volume per capita might not be much greater today than it was, say, 50 or 75 years ago. This would mean that increases in the conceptual components of GNP -- that is, those reflecting advances in knowledge and ideas -- would explain by far the major part of the rise in real GNP in the United States, and presumably the industrial world as a whole.

In part, this downsizing has reflected the economic need to conserve increasingly precious space. Also, it has been a response to the need to reduce the costs of moving goods and services to their most highly valued use -- thereby conserving on energy, labor and other valuable resources. Further contributing to this process have been quantum advances in technology, spurred by economic forces. In recent years, the explosive growth in information gathering and processing techniques has greatly extended our analytical capabilities of substituting ideas for physical volume. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the twenty-first century and beyond. The purpose of production of economic value will not change. It serves human needs and values. But the form of output will be increasingly less tangible.

In the years ahead, telecommunications and advanced computing will take on an even greater role. They create value by facilitating the transfer of ideas -- that is they create value by changing the location of intellectual property -- much like the American railroads in an earlier time created value by transferring physical goods to geographic locations where they were of greater worth. In today's environment, economic value is increasingly created by moving the conceptual part of GNP -- not coal or ore but data, analysis, and insights -- from one location to another through increasingly sophisticated electronic means.

Downsizing is having a profound impact on international trade, and the policies of the world's economies. International trade in construction gravel and fiberglass insulation, for example, is limited by weight and bulk. High value computer-related products, on the other hand, are major and increasingly important components of world trade. Obviously, the less the bulk, and the lower the weight, the easier it is to move goods.

It is not surprising, therefore, to find that after adjusting for average export price changes, pounds shipped per real dollar of exports have fallen an average of almost 3-1/2 percent per year since 1970. Pounds shipped per real dollar of U.S. imports declined even more, an average of 4-3/4 percent per year. Reflecting the downsizing of tradable goods, the share of U.S. foreign trade carried by air has doubled since 1970. On a global basis, the real value of trade has grown at a 5 percent annual rate over the past two decades, significantly outstripping the growth in world domestic demand. In tonnage terms, of course, the increase has been far less.

Consequences for Financial Markets

Clearly, as cross-border trade grows, gross surpluses and deficits on current account similarly can be expected to grow. That is, owing to the forces that are acting to boost the share of output going to trade, net cross-border financial claims relative to GNP can be expected to rise.

Moreover, new technology -- especially computer and telecommunications technology -- is boosting gross financial transactions at an ever faster pace than the net transactions required to finance current account deficits. Rapidly expanding data processing and virtually instantaneous information transmission capacity are facilitating in ways that were not feasible in earlier times the development of a broad spectrum of complex financial instruments which can be tailored to the hedging, funding and investment needs of a growing array of market participants. Some of this has involved an unbundling of financial risk to meet the increasingly specialized risk avoidance requirements of market participants. Exchange rate and interest rate swaps together with financial futures and options have become important means by which currency and interest rate risks get shifted to those most willing to take it on. The proliferation of financial instruments in turn implies an increasing number of arbitrage opportunities, which tend to further boost gross financial transactions volume in relation to output.

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In summary, therefore, it would seem reasonable to assume that cross-border trading in securities will continue to expand rapidly for the foreseeable future. This implies that investors will wish to be able to adjust their holdings of foreign securities during times that coincide with their regular domestic trading hours. As a consequence, we can expect to see the move to around-the-clock trading extending to more securities.

Already, we have virtually around-the-clock trading in various U.S. Treasury securities through global securities firms with offices in the Far East and Europe as well as in the United States. Global markets for the securities of other governments are not at this time as developed as those for our Treasury securities; however, the potential exists for active around-the-clock markets in other government bonds, especially those of Japan and Germany. Such trading in securities creates a demand for hedging instruments -- especially financial futures and options -- and thus we are likely to see more such instruments that also trade outside regular domestic market hours.

In the corporate securities area, cross-border trading of shares of large multinational firms has become prominent, with considerable scope for adjusting positions outside the regular hours of the primary exchange on which the shares are listed. In many cases, these shares are listed on foreign exchanges -- for example, foreign American Depository Receipts (ADRs) are listed on the New York Stock Exchange -- or are tracked on a real-time basis, such as NASDAQ shares displayed on the terminals of International Stock Exchange members in London. In other cases, a fairly well-developed over-the-counter market has emerged.

While international securities activity has grown rapidly in recent years, trading systems have been undergoing changes -- generally to reflect advanced computer and telecommunications technology. For example, the International Stock Exchange in London moved to a terminal-based trading system at the time of the Big Bang in 1986 and the Paris Bourse has nearly completed its conversion to an electronic trading system.

Electronic trading system technology has considerable potential for around-the-clock trading. The GLOBEX system being developed by the Chicago Mercantile Exchange and the Chicago Board of Trade's Aurora system are good examples. These exchanges have recently announced that they will combine their systems, and after-hours trading of some futures contracts could begin trading on the joint system this fall. Already, the futures exchanges of Paris and Sydney have negotiated to put their products on the GLOBEX system for after-hours trading and others have expressed interest. This type of system could be adapted for trading other financial instruments.

As international securities trading has surged -- growing more rapidly than trade and output -- demands for clearing services across a wide range of financial instruments have soared, placing pressures on clearing and settlement systems. Some of these pressures arise from the greater interdependence among clearing and settlement systems. Investors today engage in a complex chain of financial transactions, often involving positions in both national and international markets, and difficulties in the clearing and settlement process in one of these markets can affect their ability to discharge obligations in others. We got a sense of such clearing and settlement problems in October 1987 when the options clearing system was weakened by large losses in the options market, and other difficulties emerged from inadequate coordination of "pays and collects" in the futures markets. A deficient clearing system in Hong Kong not only contributed to paralysis in that marketplace but cast a cloud over other markets as well.

The process of unbundling financial risk is a factor boosting the volume of financial transactions and hence increasing strains on clearing and settlement systems. Through the use of futures and options, price or interest rate risk can, in effect, be unbundled and new synthetic instruments created by shifting risk to other parties, actions which raise clearing and settlement volume. Alternately, elements of risk can be transferred through interest rate and currency swaps; in these cases, such shifting can lead to hedging needs or to arbitrage opportunities that result in additional transactions in markets for securities and their derivatives and to enlarged clearing and settlement volume, with attendant risks to clearing and settlement systems.

Another important dimension to securities market risk resulting from growing internationalization is the emergence of large multinational securities firms that increasingly act as underwriters, dealers and brokers in securities markets around the globe. A loss by one or more of these firms could impair that firm's functioning in other markets, thereby potentially transmitting a disturbance to those other markets. Such a disturbance could have ripple effects as creditors and counterparties seek to reduce their exposure to these firms and as confidence erodes in the clearing and settlement systems in which these firms are participants. Difficulties could also extend to commercial banks thought to have large credit exposure to such securities firms.

We observed the potential of such a problem emerge in October 1987 when it became evident to the markets that certain firms committed to the underwriting of British Petroleum shares in the United Kingdom stood to lose substantial sums. It is reported that for a brief period participants in the U.S. securities markets were cautious about dealing with these firms, a situation that could have gotten decidedly worse if the underwriting environment had not stabilized.

If risks associated with cross-market and cross-border securities activities are to be contained, then it is critical that large investment firms have sound internal risk monitoring and control procedures in place. Moreover, there is no substitute for strong capital positions to act as a buffer for losses.

It is worth noting that computer and telecommunications technology, while an important factor contributing to the globalization of securities markets and to certain financial system risks, can be used and is being used to limit risk. Information systems increasingly are permitting securities firms to monitor their global positions on a timely basis and virtually around-the-clock trading in some securities enables them to shed unwanted risk promptly. Such technology also permits clearing systems to monitor member positions in their own markets on a timely basis and to share member position information with other clearing systems, thereby enhancing control of overall risk to clearing and settlement systems.

The trend toward globalization of securities firms and markets -- including the move toward around-the-clock trading in a growing array of securities -- not only provides investors with 24-hour capability to adjust positions but also provides the investor or brokerage firm with more choice of where an order will be placed. Factors such as relative costs of trading in different markets, liquidity, and the timing of clearing and settlement systems thus may affect decisions about where to place orders.

Such opportunities for choice lead to more discipline being exerted on exchanges to control costs and enhance liquidity. To the degree that investors are concerned about the soundness and timeliness of clearing and settlement systems, discipline is imposed on the exchanges to strengthen their clearing mechanisms. However, to the degree that some markets seek to lower costs and add to volume at the expense of capital positions of securities firms or clearing system safeguards, risks may be posed for other markets and the global financial system more broadly. In other words, in an interdependent global marketplace externalities are significant and weaknesses in one financial center can pose serious problems for other centers.

Implications for Coordination

The Brady Commission and others have characterized our domestic markets for stocks, index futures, and options as, in effect, functioning as one economic market. It is certainly clear that the market for some securities and their derivatives has, in effect, already become a unified global market and others are rapidly moving in this direction. Such international developments obviously require a considerable degree of international coordination just as we have learned that domestic markets for securities and their derivatives require a high level of coordination.

Both the private and public sectors have important roles to play in the coordination of securities market policies. Among the areas needing attention are capital of dealers and underwriters, clearing, settlement and payment systems, circuit breakers, disclosure to investors, and accounting standards followed by securities issuers and intermediaries. In addition, coordination of insider trading rules and enforcement of securities market laws are issues of significance in the area of securities market regulation and oversight. To an important degree, more standardization in areas such as clearing and settlement and capital standards holds the promise of enhancing efficiency while at the same time strengthening market structures. Moreover, coordination of policies in these areas will act to reduce the scope for so-called regulatory arbitrage -- that is, artificial reasons for investors or securities houses to favor one national market over others.

At the present time, a considerable amount of effort is being expended to coordinate within and across borders in these various areas. In some cases, this involves regulatory authorities; in some other cases, it involves the private sector; and in still others, it involves a combination of both. For example, there are a number of bilateral discussions between the SEC and securities market regulators in other countries on issues relating to the exchange of information and enforcement of securities market laws. Also, central banks have, within the context of their responsibilities for national payment systems, been addressing risks associated with securities clearing and settlement and are working to coordinate policies on payment system netting arrangements.

The International Organization of Securities Commissions (IOSCO), a group of national securities authorities, has established various working groups seeking to coordinate, among other things, accounting standards and capital requirements of securities firms. The Group of 30, composed of private sector representatives from the securities and banking industries, recently advanced a constructive set of guidelines for securities clearing and settlement and now is in the process of seeking implementation. The OECD has established a group of securities market experts focusing explicitly on the issue of systemic risk in global securities markets.

It is important to realize that the contributions that the private and public sectors can make differ, depending on the issue. On matters such as clearing and settlement, the private sector has much to offer given its expertise and considerable self-interest in developing a sound global securities clearing and settlement system. Other areas, such as insider trading and enforcement, clearly require coordination among regulators.

Also, some matters are going to be resolved most effectively through bilateral approaches while others lend themselves to multilateral solutions. The nature and regulation of securities markets have been sufficiently diverse that a multilateral regulatory approach along the lines of the Basle agreement on capital guidelines for commercial banks may be difficult, given the entire scope of matters requiring coordination. In any event, it is important that regulatory authorities continue to monitor overall progress in this area and seek to identify and address elements of weakness.

At the present time, it appears that progress is being made in key areas needing attention. Given the diversity of traditional national standards, it may well take longer to reach agreements than we are accustomed to in our domestic financial system. It is also likely that as these coordination efforts get further along, necessary legislative changes will become more evident.

Legislative Issues

This subcommittee has heard a great deal of testimony in recent months about steps that have been taken by our national exchanges and clearing houses to strengthen existing systems and to improve coordination among markets and market participants. As these hearings proceed, you no doubt will hear many more ideas and concerns about the future direction of these markets.

It is encouraging that so many resources in the public and private sectors are being focused on these issues. It also is encouraging that so much can and is being done within the existing legislative and regulatory framework that oversees our financial system. With a notable exception, we at the Federal Reserve Board do not at this time see a need for major legislative changes of our securities laws and regulatory structure.

In the previous Congress, the Senate had passed a bill that would have broadened the powers of banking organizations in the securities market area. We supported that bill on the grounds that our banking organizations have a lot to contribute to the development of a stronger and more efficient securities market, both domestically and globally. The formula embodied in the Senate bill last year would enable our banks to become more competitive in these markets but in a manner that would not jeopardize the safety of the commercial bank entities or the federal safety net applied to the commercial banking system. We trust the Congress will return to this matter promptly.

In closing, the stability of our financial markets must, of course, at root, rest on the performance of the world economy. Thus, at the very top of our consideration in maintaining a sound financial structure is the pursuit of sound economic policies, both domestically, and to the extent relevant, on a coordinated international basis. At the same time, we must seek to strengthen that financial structure through appropriate market reforms, recognizing that even a system with formidable safeguards will be unable to insure against a disruption resulting from a massive speculative imbalance. Through the cooperative efforts of the private and public sectors, we can go a considerable distance in improving the safety and soundness of our financial market systems but we cannot realistically expect to eliminate all risks to these systems.

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Senator **Dodd**. Thank you very much, Mr. Chairman, for that testimony.

We've been joined by several of our colleagues. Let me ask Senator Sasser or Senator D'Amato or Senator Gramm or Senator Sanford if they have any opening statements or comments they would like to make. Certainly any opening prepared statements will be included in the record.

Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Well, Mr. Chairman, just let me make one very, very brief comment if I may.

I'm pleased to see Dr. Greenspan here today before the committee and I can think of no person in a better position to comment authoritatively on what's happening in the international markets than Dr. Greenspan. But in particular, I want to compliment Dr. Greenspan and the Federal Reserve for apparently easing monetary policy. I think the Fed's recent move to ease interest rates is going to help our domestic economy and I think it will certainly help us internationally.

I don't know where we're going to be 10 years from now with regard to the international financial markets. We now see that Tokyo has surpassed New York and 50 percent of the world's capitalization now goes through the Tokyo markets, while just 30 percent goes through New York.

So I will be pleased to hear further from Dr. Greenspan. I have a few questions I would like to ask him later.

Thank you, Mr. Chairman, for convening these hearings.

Senator **Dodd**. Thank you, Senator Sasser.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, let me commend you for calling these hearings.

As you well realize, the economic strength of this country depends upon our ability to tap capital markets around the world and the best way for American companies to raise capital is through a strong, efficient, internationally competitive financial services industry that we have here in America.

Now this subcommittee and the full banking committee need to be active in ensuring both the integrity of our securities market and the competitiveness of American firms in those markets worldwide.

We also, I think, Mr. Chairman, must see to it that there is fair play in these markets in foreign places since we have given fair play to those foreign competitors who seek access to our markets. And I would be interested in asking Chairman Greenspan several questions as it relates to what he's been able to detect, particularly as it relates to the Japanese Government, in whether or not they are opening up their markets to our primary dealers as we are to them. I think that's an important area of concern and I know the Chairman shares in that concern.

Senator **Dodd**. Thank you very much.

Senator Sanford.

Senator SANFORD. Mr. Chairman, thank you very much. Dr. Greenspan, thank you very much. I have a statement that I would like to put in the record and make here just one point that is in this statement.

I was somewhat surprised, disturbed maybe, too, to see in the report that was prepared for you that on a gross basis in the United States new corporate equity issues raised modest amounts of capital but after netting out deductions due primarily to corporate reorganizations the equity markets represent a net outflow of capital, which I find extremely disturbing. It goes to a number of questions, including the differences that was also pointed out in this report in the patterns of holding between individuals and institutional investors, and that raises the question of corporate governance. If we look at the votes in a few corporate proxy decisions or corporate takeover cases, and so we see a structural change that comes maybe from the laxity of properly regulating leveraged buyouts and takeovers which has to figure in the accumulation of capital and how corporations are financed in a way that I think is very much related to the subject of these hearings and certainly is a problem that we have too long neglected.

I will just put my statement in. I apologize, Mr. Chairman. As you know, I have to go to the Foreign Relations Committee and see if we can get the foreign aid bill passed before we get to globalization of financing and do something in the interim.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman, and I would like to welcome Chairman Greenspan and our distinguished panel of witnesses to this hearing. Today's subject, the globalization of the securities markets and what, if anything, needs to be done to ensure cooperation where needed and changes to ensure fairness to all, is indeed a complicated and important one.

I must say I was a bit disturbed to read the conclusions of a report that our Congressional Research Service prepared at the request of Senator Dodd. I'd like to quote the four summary "points of interest" from that report. The report notes that:

(1) for the first time, in 1988 volume on the Tokyo Stock Exchange exceeded volume on the New York Stock Exchange;

(2) the structure of equity ownership in the three major markets exhibits major differences, with individual ownership predominant in New York, but playing a relatively minor role in Tokyo;

(3) bond issues rather than bank loans are now the preferred channel for raising funds in international capital markets; and

(4) on a gross basis, in the United States new corporate equity issues raise modest amounts of capital, but after netting out deductions due primarily to corporate reorganizations, the equity markets represent a net outflow of capital.

Each one of these general conclusions raises many concerns for me. We have always thought of our equity markets as the fairest, best, largest and most efficient way to raise capital in the world. Now, those conclusions must be reexamined. If our corporations no longer raise their funds through equities, we may be experiencing fundamental changes in our capital markets that may require changes in way we regulate and examine issues of both debt and equity. On the other hand, these changes may be a cyclical change, in part a result of skittishness by small investors to reenter the market following the October 19 crash.

The differences in the patterns of holding between individual and institutional investors is also significant, particulary as we examine issues of corporate governance and look at who votes in major corporate proxy decisions or corporate takeover cases.

The dominance of the Tokyo market is extremely disturbing, as concerns are frequently expressed about the height of that market, its relationship to the volatile dollar, and to concerns about trading patterns, as many U.S. firms are still struggling to obtain seats on the Tokyo stock exchange, and barriers still exist to full participation of U.S. firms in the financial markets in Japan.

I think the increasing globalization of the markets points to the need for greater regulatory control and I am pleased that the Committee is considering S. 646, the International Securities Enforcement Cooperation Act of 1989.

Again, I commend you for holding this hearing, Mr. Chairman, and I look forward to the testimony of our witnesses on this interesting and complex subject.

Senator DODD. Thank you very much, Senator Sanford.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me welcome to our committee the distinguished Chairman of the Board of Governors of the Federal Reserve System.

Mr. Chairman, we have a one-world financial market, whether we like it or not. I think what we debate in this committee is the role we are going to play in that market. Are we going to be the leader in that market, which we have always been and which we have every right to expect to be in the future, with enlightened regulation, or are we going to step aside and grant that leadership to somebody else?

It seems to me, Mr. Chairman, that we have a delicate choice to make here. On the one hand, we want to allow innovation to occur. I suspect in the next 20 years there will be tremendous financial innovations. We want to allow those innovations to occur. We want America to be competitive in the evolution of new financial services, something that we have a tremendous advantage in and that we are a world leader in. On the other hand, we want to promote safety and soundness. That's going to be a very difficult task. I look forward to working with you, Mr. Chairman, and with Dr. Greenspan, to see that we achieve that objective.

I think there is a flip side to protectionism in goods, and I think it's protectionism in services. I think we have to be very mindful of the dangers of protectionism in terms of what it might do to lessen our ability to be competitive on the world market. We've been blessed in this country by being the financial center of the world since about the end of World War I. I don't see any reason that ought to change. If we stay the financial center of the world, then progress that occurs everywhere benefits us. And since the choice is America benefitting from the growth of the world market or somebody else, it might as well be us.

Thank you.

Senator DODD. Thank you very much, Senator Gramm.

Let me point out as well, Senator Sanford made reference to it and I want to personally thank the Congressional Research Service. They prepared a rather comprehensive and very worthwhile descriptive material on the global financial market institutions which has been very, very helpful to us and I know the press has received some copies of it and my colleagues have as well, and I presume that your office has received it as well. It's very helpful and I thank them for it.

[The report referred to may be found in additional material.]

Let me start the questioning, Mr. Chairman, on one of the issues you raised. In fact, Senator Gramm has just alluded to it. I think every one of our colleagues to one degree or another have touched on it. That is this notion of coordination of global markets. The first place to look obviously is what's going on domestically. Before we start jumping ahead and start to draw some conclusions about our ability to achieve coordinated efforts on the international level, I think looking at what we're doing here at home may be instructive.

One of the lessons from the 1987 market break was that our securities options and futures markets domestically—and you make reference to this—are one market. At least that's a conclusion that many have drawn. Since October 1, 1987, we also have had a lesson in the difficulty in getting the different regulators of those markets and the participants of those markets to agree on a given set of practices. Clearly, we've seen some progress in a number of areas, but in certain areas we've seen continuing disagreement among U.S. market regulators. There is no tie-breaker among the regulators, no real way of forcing compromise. The margin area—I mentioned to you, Mr. Chairman, I spent all day Monday in Chicago at the Board of Trade and CBOE and the Midwest Stock Exchange, and I got an earful from CBOE about margins. There are some significant areas of disagreement among the futures and options and stock exchanges and between the Securities and Exchange Commission and the CFTC. Coordinated clearance is another area where agreement has been very slow in coming, as you know.

Which leads me to three questions.

First, do you believe that the one-market theory applies to global markets? Are domestic and foreign financial and securities markets so interdependent that we must look at them as one, as you suggested in page 15 of your testimony? Second, if we have difficulties in forging compromise and agreement among regulators of our domestic markets, what do you see as the outcome for greater coordination on the international front?

I wonder if you might, identify areas where you believe international coordination agreement is likely and areas where you think it's unlikely.

Third, and finally, the notion of a plan for crisis management. Now I realize we're not talking about something that may exist in great detail on paper, but has there been any kind of an informal agreement among regulators in various countries about what to do in a market crisis? It's been pointed out on numerous occasions before this committee, in October of 1987, while our attention has been focused almost exclusively on what happened here domestically, that if you look around the world on those dates you saw a reaction in markets right around the globe. So how do we try and deal with that and what coordinated steps are being taken?

Mr. Hormats, who will testify later, points out in his testimony that last year there were 181 companies that were listed in both the New York and London Exchanges. That leads to the question, obviously, if U.S. circuit-breakers go into effect and close our markets for a period of time, do traders simply move to the International Stock Exchange in London and continue trading?

At any rate, the issue of coordination is one that is essential and sort of a threshold question as we look at the whole issue of globalization.

Mr. Greenspan. Mr. Chairman, let me just take a step back in response to that series of questions and try to set up a framework for answering them because implicit in the issue of both domestic and international coordination is the question of how to remove systemic risks from the system, both domestically and internationally.

The reason why you see a considerable degree of what seems to be lack of agreement about different issues is that we are still struggling with a very major and crucial tradeoff that exists in the regulatory area.

I think I can best describe it by asking the question what would be the ideal international or even domestic securities market system with respect to settlement, clearing, execution and the whole variety of financing that is associated with it?

That clearly would be a system which, if we could devise it, would have a real time execution, perhaps on screens automatically through a bid and ask system, with instantaneous verification, clearing, settlement, and with a tie into the central banks so that there is in fact not only final settlement at that particular point but also so-called same-day money, or in the way we're going now, same-minute money.

That would eliminate all of the float in the system, and it is the float in the system which is the major element associated with systemic risks and dangers, meaning that when there are timing differences between when a trade takes place, when it is verified and checked, when it is settled, when it is paid—if there are time lags in any of those areas—you have set up a system which can break down.

The problem with reaching the ultimate ideal, meaning going down to zero float, is that it is extremely expensive to implement in terms of resources. We therefore have, as we have in so many economic areas, the problem of trading off how much in the way of real resources does one want to commit to this total type of system because unless and until what is now a T-plus five—meaning a 5-day lag on the clearance and settlement of equities in the United States—so long as there is anything lagged in the system, there is the possibility of breakdown.

But to get it down from plus five to plus one and especially down to instantaneous settlement is a tremendously expensive and very time-consuming process which we are working towards.

The reason why there are differences of opinion and why we are in fact seemingly at odds under certain conditions has nothing to do with the ultimate goal. Everybody agrees that in the long run, whether it is 10, 15 or 20 years from now, we will have a real time system. The question is, how do we get there and how quickly do we get there?

As a result of this, we find that the coordination process, while very active, is struggling with this area but it is progressing. We have made I think considerable progress in the United States. For example, I think the numerous discussions and actions taken by the New York Stock Exchange and the Chicago Mercantile Exchange have been very useful. We have a task force which has been meeting periodically, but the staffs have been meeting much more often, and we are continuously focusing on these particular issues.

We don't yet have the single market globally that we have in the United States in the sense that, with the exception of periods when there are very disruptive movements like October 1987, all stock prices move together. The evidence is that our markets don't move all that closely together with the exception of the stocks that are very similar from one market to the other. The markets have not yet fully integrated into a single value system.

My impression is that they will. We are progressing in that direction. It's slow. But we have not yet reached it in the sense of that full integration that we seek, which is essentially a measurement of to what extent the individual stocks move with one another.

In the United States, individual stocks move with each other to a much greater extent than our stocks move with Japanese stocks or British stocks.

My impression, however, is that those differences are going to gradually disappear as we integrate the system 10 or 15 years from now.

We cannot get there sooner basically because, despite the extraordinary technology that we have already applied—and it's been unbelievable in certain respects—we are at the outer edge of technology and still moving. We are making very considerable progress.

Until we get to that point where systemic risks are completely eliminated by the system, we are endeavoring to engage in very considerable coordination within the United States among the regulators. We all deal with one another. We work with one another, and I thought we worked exceptionally well together during the crisis of October 1987.

We have similar relationships with our international colleagues—the Group of 10 central bankers, for example, meet periodically. We talk about a lot of these issues. And in the event of a crisis, as indeed occurred back in 1987, we were in touch with each other. And we discuss in various forums ways in which we can coordinate. For example, the issue of circuit-breakers is one that is now currently being discussed in a forum of the OECD. For obvious reasons you cannot have circuit-breakers in one country's market and not in the other if similar stocks are being traded, and that's one of the issues that is being discussed.

I don't know whether I have addressed all of your questions, but I've tried to.

Senator **Dodd**. I'm sure we will continue. That issue of coordination springs up in every issue that is addressed in terms of internationalization.

Let me turn to Senator Gramm.

Senator **Gramm**. Thank you, Mr. Chairman.

Chairman Greenspan, in your statement you say that if we want to have a substantial impact on our competitiveness, on the strength of our financial markets, there are probably two things we could do that you rate as being primarily important—and I agree with you and so obviously I want you to take my time and elaborate.

I enjoy being preached to when I like the sermon, and there are sinners here who need to hear the sermon.

Your first point is the need for a sound economic policy, including balancing the budget; and your second has to do with the bill that we passed in the Senate last year related to banking powers, which died in the House of Representatives.

I'd like you to take my time, Dr. Greenspan, and elaborate on the importance of those two fundamental policies in terms of the strength of our financial markets and our competitiveness on the world financial market.

Mr. **Greenspan**. Well, Senator, the first issue of sound policy essentially gets to the stability of the system. It should be fairly clear that if we had a stable stock market, stable bonds, everything in a non-inflationary environment which was balanced, we could have a highly inefficient clearing and settlement system. We could have significant lack of coordination and there would not be any substantial systemic risks to the system.

Conversely, we could have the most sophisticated type of system short of this real-time system, and find that despite the extraordinary endeavors of cooperation and coordination and every conceivable regulatory control that one could conceive of, and if you have a highly inflationary imbalanced financial system which is extremely volatile, you will not be able to prevent significant disruptions.

So that's the reason I said at the end of my statement that, above all, when we think about systemic credit problems, let's remember that the most efficient way to prevent them and to contain them is to avoid their occurrence. And this is essentially why a non-inflationary, stable set of economic policies is at the top of the ladder.

On the issue of the question of enhancing American commercial banks' capability of competing in the world market, there is no question that we are in effect being significantly suppressed by the Glass-Steagall restrictions and that if we had congressional passage of the bill which passed the Senate last year I think I would argue that our competitive capabilities in the world markets would be significantly enhanced.

Senator **Gramm**. It's very difficult to quantify anything like that, but in general terms, how non-competitive are we in terms of the regulations we impose on our banks as compared with our international competitors?

Mr. **Greenspan**. You're quite correct, Senator, it's almost impossible to be quantitive because it's not only the issue of the regulations that are imposed, but the capability and perseverance of the particular regulated institution in trying to adjust and offset the force of the regulation in a way which is legal but tries to soften the impact of that regulation. Some are capable of doing it better than others and it's difficult to make the judgment.

All one can say is that it is not an insignificant problem for American banks, and I think the Japanese, who have the equivalent in Article 65 of their banking laws, and who are very seriously focusing on making major revisions in that as well, and I should trust that we don't want to be the laggard in that area.

Senator **Gramm**. Thank you, Mr. Chairman.

Senator **Dodd**. Thank you, Senator Gramm.

I would just say on that banking bill, I think all of us—I forget the vote on that, but I think there were only four or five Members of the Senate against that banking bill.

Mr. **Greenspan**. I think it was four.

Senator **Dodd**. We hope we'll come back to that. The chairman isn't here. As soon as we get the FSLIC out of the way, we'd like to return to that issue.

Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Following on the question, Mr. Chairman, about Glass-Steagall, thanks to General Douglas McArthur, the Japanese have their own version, as I understand it, of Glass-Steagall, and yet we see that nine of the ten largest banks now are Japanese. I think Citicorp ranks eighth out of the ten largest banks. I think that's the only U.S. bank in all of the ten. It doesn't appear that Glass-Steagall, the Japanese version, has hampered the growth of Japanese banks and we see that now the Tokyo Stock Market accounts for about 50 percent of the equity capitalization in the world, whereas New York, according to what I understand, has fallen now to 30 percent.

So how do we rationalize the growth of Japanese banks and the growth of the Japanese capital market with the fact that they have their own Glass-Steagall strictures written into their banking regulation, as I understand it, by—somebody said Douglas McArthur on the decks of the U.S.S. Missouri. I doubt that. But at least we put in their regulations.

Mr. **Greenspan**. Well, Senator, I think that, while it is certainly true that the assets of the Japanese commercial banks exceed ours even on a consolidated basis, including savings banks on a worldwide basis, the issue of competitiveness really gets down to the question of rates of return on equity. Here, American banks have a much higher rate of return on equity than Japanese banks.

The question of Glass-Steagall is really not immediately relatable to the size of Japanese banks because it basically gets to items that are not on the asset side of the commercial bank and gets to the question of the merchant bank capabilities of a total institution.

Our capabilities are still, as best we can judge, quite competitive in that area and both the Japanese and ourselves are inhibited by our Glass-Steagall and their Article 65.

The crucial issue is to look not at the commercial bank itself in which those assets are very large, but to look at the merchant banking institution capability of the total system. And I would say at this particular stage that when one looks at profitability and effectiveness in the marketplace, American banks are still quite competitive and my concern about the Glass-Steagall is that as we continue to internationalize, as trade continues to grow as a share of world GNP, and as financial services become ever more globalized, that we are in effect inhibiting our institutions from fully participating in that.

Senator **Sasser**. To shift gears just a moment, Mr. Chairman, you're in contact with the central bankers of the world's major powers. In fact, you're probably in contact with central bankers of not so great powers. The question I want to ask you is, how seriously is our self-imposed fiscal discipline that we call the Gramm-

Rudman-Hollings Act taken by investors overseas? Do they really think we are making any progress on deficit reduction and do they take seriously the efforts to hold to the Gramm-Rudman-Hollings schedule or not?

Mr. **Greenspan**. Senator, I think that they have pretty much the same views that we do; namely, that Gramm-Rudman-Hollings is not the type of fiscal budgetary problem that one would teach in Public Finance 101 as an ideal vehicle to restrain the budget, but it clearly has a marginal effect of, I would say, significance. My view is that, with all of the problems, I think it has been and will continue to be a very important element in restraining our budget deficit and I would suspect that the majority of the world central bankers pretty much hold to the same view.

Senator **Sasser**. One final question because my time is running out, Mr. Chairman.

The overriding theme of today's hearing is the globalization of capital markets. National boundaries we've learned have very little meaning in today's economic development and, frankly, I think that's one reason some of our economic forecasts have been so erroneous over the past decade. Capital is fungible. It's an international commodity that flows across international borders with really not much regulation at least as between the major industrialized powers in the free world.

Now what I've always wondered is if capital flows so easily between countries, why is it the conventional wisdom that our cost of capital here in the United States is so much higher than it is in other countries? I think that is a very inhibiting factor on our economic growth. It appears to me that cost of borrowing ought to be approximately the same if in fact we are one worldwide capital market, and why isn't it?

Mr. **Greenspan**. It would be, Senator, if we had a single currency. The reason for the differences is not the national border, but the difference is in the currency units which are not locked together. In the period, say, at the turn of the century when the gold standard was in place and we had exchange rates locked together, interest rates did indeed tend to move very closely together, as in fact they do with some differences within the EMS.

The problem basically is that so long as we in the United States can create indefinite quantities of U.S. dollars and the Bank of Japan can create yen but we can and they can't create dollars, for example, you have rate differentials which reflect differences in currency policies, not the homogeneity and the flow of capital.

Senator **Sasser**. Well, are you saying, Dr. Greenspan, that if we went back on a gold standard internationally and our currency—not just our currency but the currency of all of our trading partners was gold-backed, then we could see interest rates that would be uniform between those that had gold-backed currencies?

Mr. **Greenspan**. What would happen is if you fixed exchange rates, which is the equivalent of creating a single currency, these would be the convergence of interest rates, and price levels. There would be some differences but I don't want to get into some of the technicalities of this.

We have in fact the ideal example which is the 50 States of the United States, in which we have got different fiscal policies and we've got different types of internal policies in every different State, but we have a uniform currency and a single set of interest rates.

Senator **Sasser**. Thank you.

Senator **Dodd**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

Mr. Chairman, I would note that there were several of us who voted against the banking bill last year on the Senate side because we felt that it simply did not go far enough and we have offered an opportunity to rectify that situation and would look forward to your strong support in a comprehensive banking reform legislation which is sponsored by Senator Cranston, Senator Gramm, myself, and I don't know if it has Senator Dodd's name on it. This bill I think is the kind of thing that really strengthens the financial services industry and would make us much more competitive. But enough of the self-aggrandizement.

Mr. Chairman, it's good to see you again. I'd like to just touch on two points, one probably somewhat controversial.

I was concerned when the New York Federal Reserve Bank gave the opportunity and opened it up as primary dealers to some of the foreign governments and foreign firms, and I'm talking about Japan in particular.

What concerns me is the kind of treatment that the U.S. firms are receiving as it relates to the issuance of Japanese government debt. The fact is that under the trade act I believe that you have the responsibility of making a determination in August as to whether or not there is compliance with the national treatment standards.

Can you tell me at this time whether the Japanese are in compliance?

Mr. **Greenspan**. Well, Senator, as you point out, we are required by law to embark upon an investigation which is underway in full force and we are scheduled to report to the Congress. I believe that provision becomes effective on August 23rd. Until that investigation is complete, I would just as soon avoid the preliminary results.

Senator **D'Amato**. Well, let me for the record at least make this observation. I believe that in matters of trade repeatedly we have suffered and not because we don't have competitive products and certainly in the area of the securities industry we have the ability to compete. We have the ability to market. But there is a persistent pattern of institutional and governmental harassment that our firms have got to deal with. They themselves may be somewhat reluctant to step forth because it's difficult for them to attempt to do business in the country that they are critical of, but I don't have that burden or that liability, so I state it for them.

I will be anxiously looking, as I know many members of the Senate and this committee will be, who are interested in fair play. If they have access, unimpeded, as it should be, unencumbered by regulations which are discriminatory, we should have the same. We face a situation where there are regulations which are discriminatory, which are designed to impede our participation in that area of commerce that we are very much concerned about—the international securities industry.

So for the record, so they will understand, we are going to be looking at this.

Mr. Greenspan, you have been a leading voice in the past decade—one of the leading voices—and said that one of our problems as it related to our deficit problem, to our trade imbalance, is the low U.S. savings rate. You've frequently cited this as a cause of our problems, of growing foreign ownership of U.S. productive assets and the flow of profits overseas.

A two-part question. Is there anything that you feel can be accomplished outside of the scope of the tax code that would promote savings in the United States?

My second part would be that if you could use the tax code, would you do so to encourage that savings?

I think, for example, that we suffered a terrible—Senator Dodd and I waged an aggressive battle and we came close to winning—we lost it by one vote. I think it was a terrible blow to the American people, particularly working middle class families where you have two incomes coming in as it related to the loss of the IRA's. For the first time we were beginning to get people to save.

Senator DODD. If my colleague would yield on that, I don't know if you saw the Merrill Lynch study, but one of the criticisms of the IRA program was that it just transferred savings and didn't create new savings. Merrill Lynch indicated that about $138 of the $180 billion between 1982 and 1986 that was saved was actually new savings.

I don't know if you agree or disagree with that conclusion, but that was one of the criticisms at the time. I just point that out to my colleague.

Senator D'AMATO. I think that was a terrible loss to the American working middle class families, a terrible loss to the economy. But be that as it may, outside of the scope of the tax code, are there any suggestions that you could make to encourage people to save? And within the tax code, would you explore the use of the tax code to bring about— whether it's IRAs or another program—to bring about increased savings?

Mr. GREENSPAN. Senator, outside the particular short-term problems that we now are confronting with the S&L situation and the budget deficit which is scarcely a short-term issue, if you look beyond those things which have taken our greatest attention recently, I would say you are pinpointing the area where our greatest national economic problem exists; and that is our deficiency in private savings.

I have, in slight despair, been arguing that the only way that we seem to be able to get domestic savings up is to create a very large federal government surplus, but obviously the ideal way to do it is to encourage private savings and I think that we, the Treasury, and the Council of Economic Advisers will be attempting to expand our knowledge of means and methods, either legislatively or otherwise, to confront this problem.

On the issue of would I use the tax code if it were working to induce savings, the answer is, yes, with one caveat; namely, I thought that the Tax Reform Act of 1986 in its totality was a very valuable reform, and I would hate to unwind it by introducing new legislation. I think the National Bureau of Economic Research has recently come to the somewhat similar conclusion that you referred to, Mr. Chairman, with respect to what the tax data are showing on the impact of IRA's. I should also say, however, that it is still a disputable issue. There is no consensus amongst economists at this particular stage as to whether the IRA was a significant net contributor to private savings or not.

Senator D'AMATO. Mr. Chairman, my time has expired. As usual, we're always heartened to have your incisive testimony and I thank you, Mr. Chairman, and I look forward to working with you and the chairman to revisit the question as to how we can encourage that savings. I think it's most important. I'll just say this for the record. When we did away with the IRAs, this senator, the only savings we ever had, was my participation in it and now I don't participate. So I don't think it's a transfer of savings as many people have said. I point it out as an individual case and I just think there are lots of other Americans in that same case. So I'm saddened. Even if they call it by another name, I concur with you, we've got to do something to stimulate real savings in this country.

Senator DODD. I should point out just for the record on that very point, if you look at Japanese private savings, West German private savings, and the U.S. private savings, the statistics are in Japan it's 16 percent of GNP, in West Germany it's 12 percent of GNP and in the United States it's 4 percent of GNP. A good argument is made by many, and I find myself in agreement, is that while the deficit is a problem, the issue isn't so much the deficit but the simple fact that America doesn't finance our own debt.

Mr. GREENSPAN. That's certainly true.

Senator DODD. That's certainly the issue more than anything else. As a percentage of gross national product, a thing like IRA or something similar—and I certainly support the conclusion you've drawn—would substantially change that dynamic it seems to me, or at least have the potential for doing that. So it's a very important issue and I thank my colleague.

Senator Shelby.

Senator SHELBY. Thank you.

Mr. Chairman, I want to follow up on the same note that Senator D'Amato and you were talking about. That's the external debt of the United States. I believe, as you've said here before—I don't know if this is your phrase—that it's a fundamental problem and it is a problem that just hasn't gone away. We're not going to wish it away. And I know that we do make social policy and we make economic policy to some degree at times by laws we pass up here, and what Senator D'Amato I think was alluding to and Senator Dodd is, we're going to have to do something about the savings rate. We're going to have to encourage it and I don't think we can just do it by verbally encouraging it. We're going to need some leadership, as you well know, Mr. Chairman, from you and the Council of Economic Advisers and others because there has been a dispute and I've read a lot of it from time to time between economists as to what way we should go.

But the fundamental problem remains the same—the external debt of the U.S. is growing each day because we, as you pointed out here before in this committee, Mr. Chairman, we do not finance our own deficits.

Now moving to another step, isn't it the debt instruments that are mainly—I know there are other things that are traded in the global markets of the world, and a lot of it is our bonds reflected by a lot of our external debt in the U.S.?

Mr. **Greenspan**. Well, there's no question that one of the most effective 24-hour, around-the-clock market is in U.S. Treasury securities.

Senator **Shelby**. Debt instruments as opposed to equity, is that right?

Mr. **Greenspan**. The answer is it's mainly debt instruments, that's correct, but there are a good deal of international equities. There's a significant amount of New York Stock Exchange listed stocks which are also traded in London and Tokyo.

Senator **Shelby**. If—and that's a real big if—if we were to be able in the near future, not too near but the near future, do something about our savings rate, therefore able to finance our deficits hopefully as they come down to some reasonable target or are obliterated, what impact would that have on the globalization, at least the volume of the trading around the globe? It would have to have some, would it not, Mr. Chairman?

Mr. **Greenspan**. You mean if we bring our current account down?

Senator **Shelby**. Right.

Mr. **Greenspan**. Well, I think as I stated in my formal testimony, Senator, the way to look at the proliferation of international claims that's generated from the United States, for example, is to first look at our current account deficit which we must finance, but that's a net figure. That includes gross sales less gross purchases, for example. On top of that, however, is a significant increase in the grossing relative to the net. So that even though we reduce our current account deficit to zero and stop the growth in the net debt owed abroad, the amount of instruments denominated in dollars emerging from the United States would still increase and could still be quite significant wholly because of the unbundling of risks that would still be occurring and the technology which has enabled so many different types of financial instruments to be produced to reshuffle risks and to create a vast amount of cross-border transactions. But the net debt figure would stop growing.

Senator **Shelby**. Mr. Chairman, what significance or how much significance is the 1992 deadline of the European Common Market going to have on the globalization? Is that going to just consolidate more and more of what's in Europe and that would have an outward impact on the globalization? Do you have any comments on that?

Mr. **Greenspan**. Well, Senator, I think, first of all, in mid-1990 there's going to be the removal of the remaining capital controls within the European Community, and the Spanish finance minister has just announced that they will be entering the EMS.

The increasing creation of instruments and freer capital controls undoubtedly will be an element of the 1992 accord and a very considerable part of the effect is going to be whether or not the so-called Delors report on central bank convergence is implemented in part or in full, and that is an unsettled issue in the EC at this particular stage.

But there's no question that we're either talking about modest increase in globalization or significant increase in globalization as a result of the actions in the European Community. The size of the change is unclear, but that it is an increase there is no question.

Senator SHELBY. My time has expired. Thank you.

Senator DODD. Thank you very much, Senator Shelby.

Let me just very quickly, Mr. Chairman, return to a couple of issues. In response to Senator Sasser's questions, talking about the statistics which we've all referred to this morning in terms of the numbers of U.S. banks and the top 40 and what's happened to the New York Stock Exchange vis-a-vis the Tokyo Exchange in terms of equity capitalization. He didn't get to the issue of the relative size of securities firms, but there again you could look at some names and I suppose give a pretty good speech somewhere about what's happening to America's competitive position.

You point out, of course, that return on equity is a statistic that ought to be kept in mind and in those areas we do better than our Japanese competitors.

I wonder if you might just give us some indication of whether or not you see, absent any real fundamental change in some of our regulatory schemes or law, if you see this trend continuing? In other words, a growing foreign dominance in financial services, at least based on the data we presently draw upon. Is that a trend that in your mind is just not going to change, absent any fundamental change?

Mr. GREENSPAN. You mean, Japan versus the U.S.?

Senator DODD. Yes.

Mr. GREENSPAN. I think it's very difficult to say. There's nothing inevitable about it at all and certainly if we repeal or significantly alter Glass-Steagall that would in a major way improve our competitive capabilities.

But I do think that changes in the international financial community are occurring very rapidly and it is just as easy to lose share as gain share. In other words, I don't see anything inevitable in the structure of Japan's institutions or their commercial banking and investment banking institutions which means that we just fold up our tent and forego competitive relationships.

On the contrary, I think we reinforce each other and we are a help to each other and I think everybody benefits as a consequence of that. I think one has to distinguish, however, between the markets and the institutions. For example, the most sophisticated, most effective financial services marketplace is in the United States and we are still superior. Japan is closing the gap. London is moving fast. But we are still predominant.

Japanese banks have moved worldwide and in a sense they have picked up a significant market share at our expense in the Eurobond market, for example. However, that trend has partially reversed. My recollection is that we had 30 to 40 percent and the Japanese had 10 to 20 percent and we lost 10 or 15 points, but we gained back some. It fluctuates. I would not at this particular stage want to project trends because I don't think they are really projectable. It really depends on competitive capabilities and I think that our institutions— both our commercial banks and our securities firms—are acutely aware of where the competitive advantages are.

One need only look, for example, at the difficulties which the Japanese securities firms are having in the United States. They are not very profitable. They've had to shrink their operations some. They have not been able to compete with us in that respect. I think that there's a presumption here——

Senator DODD. Is that because of something they are doing structurally? Reducing size is something all securities firms seem to be doing.

Mr. GREENSPAN. Well, they are—you have two or three gentlemen on your next panel who are far better able to answer this question than I, but I think the facts are clear that they have not been the major success that most American firms thought they would be in the New York market. That does not mean that they may not just spring forward with new products, new insights and the like.

Senator DODD. I apologize for jumping with you here, but Senator Shelby raised the issue of Europe 1992. Most people that I talk with seem to draw the conclusion that financial services is one area where the European Community is apt to have its act together pretty quickly, unlike agriculture, for instance, where it will be a significant problem for some years to come.

How do you see what is occurring? Are you optimistic about this in terms of access to that market on the part of U.S. firms or is there a growing concern in your mind that we may be looking at a fortress Europe when it comes to financial services?

Mr. GREENSPAN. I'm optimistic, Mr. Chairman, first, because the concept of fortress Europe strikes me as a conceptually difficult one. The EC is essentially an institution based on freeing up barriers, freeing trade, freeing capital, and it is psychologically and hence institutionally very difficult to have an organization which is trying to break down barriers internally and construct them on the outside.

Senator DODD. Isn't that in fact one of the arguments they use in breaking down the barriers internally?

Mr. GREENSPAN. What, that they would be able to——

Senator DODD. That they would in fact create a stronger community. We may be giving up something here but we're gaining something there.

Mr. GREENSPAN. I think it is certainly a stronger community but it is not a stronger community perceived as one of being protectionist.

Clearly, while we had some questions about the original so-called second banking directive which related to the issue of reciprocity in handling of bank charters, the most recent clarification by Mr. Leon Britton of the EC is clearly very satisfactory to us in the sense that it certainly comes to grips with our concerns and we see no major problems emerging. There are some minor elements which are still under discussion, but I am fully confident that no real problems will emerge in the banking area.

In the financial services area, other than commercial banking, they are working in the same direction, and we would expect when that is finally completed that that will be satisfactory as well. But that is not yet a fact.

Senator DODD. But you are generally optimistic?

Mr. **Greenspan.** I am most certainly.

Senator **Dodd.** Let me come back to a point I raised with you earlier and that was the coordination aspects of the globalization of markets as we look down the road. I appreciate your comments earlier regarding that matter.

But there's a question, really, of who speaks for the United States in these areas when you start talking about relationships between various institutions. All of our witnesses, yourself included, have talked about harmonization of rules related to financial services. In fact, one of our witnesses tomorrow has written in his statement that he advocates, "the creation of level playing field for all participants regardless of the form of organization." He points to the Basel Accord capital guidelines for banks and says similar initiatives should be undertaken for nonbank institutions.

John Heimann also says in his written testimony that he will give us later this morning, "There should be a mechanism to review the regulation of nonbanking institutions on an international basis." He goes a bit further and says, "We need to develop a general conceptual framework defining the basic purpose of and the need for regulation of financial institutions and what types of harmonization across institutions and countries are desirable."

My question to you is, (1) do you think that's desirable; and (2) who should be the spokesman in that area? As case in point, and this may delve into too much minutia but I think it's the kind of question people raise.

If you start looking at capital requirements for securities firms, is it the Federal Reserve or the SEC who negotiate with the Japanese Ministry of Finance which regulates both banks and securities firms in that country? Which U.S. regulator talks with German bank regulators? With this whole notion of trying to establish that level playing field, if you accept that basic notion, then the question of who speaks for this country in these various matters is certainly raised when you start to talk about this goal in more specific terms. I wonder if you might comment on that.

Mr. **Greenspan.** Well, Mr. Chairman, I would certainly agree with Mr. Heimann on the issue of having to define what it is you're trying to do before you try to do it. And there's no question that we have to define what purpose we're endeavoring to achieve and what goals before we try to form the coordination and integration of policies or we will find we are creating a series of conflicting goals and policies.

I view the Working Group which was set up by the President subsequent to the stock market crash as the appropriate vehicle through which the question of how we organize this should be essentially resolved. We have an ability there to make decisions on an interagency basis bringing together all the views of the SEC, CFTC, the Federal Reserve, Treasury Department, and we have the capability as best I can judge in determining precisely how each aspect of coordination should be handled.

Outside of that group, we do have a good deal of bilateral relationships. For example, the SEC is having talked with the SIB, Securities Industry Board, in the United Kingdom. We generally talk in various different formal and informal ways with our counterparts abroad on these issues.

I think that there is a growing awareness of the need for this form of coordination and it is emerging in a natural way and I'm not certain that we absolutely know that there's really any urgency to speed it up. I think it's working well and moving.

But I think one outcome of these hearings is that in a sense the Congress is expressing its interest in these areas and, needless to say, when the Congress expresses interest it does get the attention of the executive branch.

Senator DODD. To your knowledge—I don't know the answer to this, but I gather that the Working Group really hasn't addressed any of the international issues yet. I don't know that. Maybe they are.

Mr. GREENSPAN. Only indirectly, Mr. Chairman. But I think we will be moving in that direction. We have not been meeting on a very regular basis in part because we've been dealing with the savings and loan problem and other issues, but I think presumably when that is passed this will move up fairly rapidly on the agenda.

The staff of the Working Group, however, has met recently, as I recall, in coordinating policies to bring up to the Working Group principals.

Senator DODD. Well, in fact I've spoken informally with the Secretary of Treasury and in fact we've written to him—Senator Heinz and I have—to ask him to respond in a number of these areas and we realize the problem has been FSLIC to some degree.

I think you're right. I think there's a danger here in overreacting, but there's also a danger in underreacting. A balance needs to be struck here. There are some clear signals that ought to raise some very obvious warning signs to us that we're entering a new era, a highly competitive one, with Europe 1992 coming on-line and what we're seeing in the Pacific Rim, and just the whole nature of the politics of the world changing—the opening up in Eastern Bloc countries, what's occurring in Poland, Hungary and the Soviet Union. All of these new opportunities and the ability of our firms and this nation to compete internationally in financial services—I don't often find myself in agreement with Phil Gramm, but I'm in total agreement with him on this. It's understandable to many Americans why we lose market share to foreign competitors in certain areas. We don't like it, but we reluctantly accept the fact that, economics being what they are, we're just not going to and cannot be as competitive in certain areas as we have been in the past.

But I think it is unacceptable to most Americans that we should end up losing or playing second fiddle to anybody in financial services. This not understandable. There is no reason in the world why this nation, given its capacity, the talent that exists in this country in financial services generally, ought to lose out competitively, in this arena. That is just unacceptable.

So I think there is a danger in overreacting to some of this, but clearly we've got to make some decisions. You pointed out that Glass-Steagall is one that you think is an important area for us to move in. Suggestions like that I think will help because clearly, while there have been differences in how to sort out some of these issues in the past, when the issue becomes the position of the United States vis-a-vis its international competitors, I think a lot of the differences that we've seen in the past evaporate. When the issue is that of international competition and the position of the United States, I think people could rally around in this Congress and I think if the issues are framed more in that light a lot of the differences that existed in the past might change. I don't know if you share that view.

Mr. **Greenspan**. I would agree with that, Senator.

Senator **Dodd**. Well, you've been very gracious with your time this morning and, as always, very, very helpful to us, and I appreciate you being here. There may be some additional questions that colleagues who didn't make it here this morning may have and they will submit them to you in writing. We look forward to seeing you again in the near future. Thank you very much.

Mr. **Greenspan**. Thank you very much, Mr. Chairman.

Senator **Dodd**. We will take a two-minute break here.

[Recess.]

Senator **Dodd**. The subcommittee will come to order.

We are very pleased this morning to welcome to the subcommittee three very distinguished witnesses who have patiently been sitting in the hearing room this morning. I hope it was as instructive for you as it was for the members of the subcommittee to listen to the Chairman of the Federal Reserve System comment on the issue of globalization of securities markets.

John Heimann is the Vice Chairman of Merrill Lynch Capital Markets. In fact, I threw a bone there to Merrill Lynch and your study on IRA's. I took a pounding a couple of years ago when I offered along with Senator D'Amato the effort to retain IRA's, at least in a restructured form. Some of the editorial comments were particularly vicious as to what our motivations were, but nonetheless, I think the recent studies have indicated that that effort was worthwhile and it was a mistake for us not to have retained that aspect of the tax code.

Bob Hormats is a highly regarded—he happens to be a good friend of mine I'm proud to say in this hearing. He's Vice Chairman of Goldman, Sachs. He's distinguished himself not only in the private sector but for many years in the public sector as well. He represents, in my view, the very best this country ought to offer of people who come in and serve in a public way and return to the private sector. He's a good inspiration for a lot of people who think the government service is a worthwhile endeavor.

Alan MacDonald is the Group Executive at North American Investment Bank, Citicorp. We're delighted you are here with us this morning as well, Mr. MacDonald.

I know all of you have prepared statements. I've cheated a bit in that I've quoted from those statements liberally in my questions to the Chairman of the Federal Reserve System. Maybe you'd like to comment on some of the things the chairman has said briefly and then get into some of the questions this morning. I'll ask you to respond in the order that I've introduced you.

John, we will begin with you.

STATEMENT OF JOHN G. HEIMANN, VICE CHAIRMAN, MERRILL LYNCH CAPITAL MARKETS, CHAIRMAN, EXECUTIVE COMMITTEE, MERRILL LYNCH EUROPE/MIDDLE EAST, NEW YORK, NY

Mr. **Heimann**. Thank you very much, Mr. Chairman.

Following your suggestion, I would like to confine my opening remarks to just a few comments on the chairman's remarks with the understanding, of course, that the testimony which has been submitted will be included in the record.

Senator **Dodd**. Absolutely. It will be included in the record.

Mr. **Heimann**. As usual, I find myself in pretty much full agreement with Chairman Greenspan, but I would like to make one or two comments about that which he said.

He strongly urged that one of the problems that face the U.S. commercial banks was the problem inherent within the restrictions of Glass-Steagall and said that he felt repeal would improve the competitiveness of the U.S. commercial banking system.

To some degree, I do agree with that, but I would like to point out that it was not only Glass-Steagall which inhibited the U.S. commercial banks; it was also interstate banking restrictions embedded in the McFadden Act and the Douglas amendment to the Bank Holding Company Act.

After all, our foreign competitors do represent the health and the strength of their domestic economies. In virtually all of the G-10 countries, the commercial banking system does represent the entire nation. They have fewer banks than we do because of their history, their culture and their tradition, but nevertheless, their strength draws across the board from the nation, whereas the United States banks until very recently and only through state action—our banks have represented small geographic areas. And this has inhibited them in terms of their growth and their size of capital as well as profitability.

So that if we're dealing with the competitiveness of the commercial banking system, I think that the issue of interstate banking must be addressed as well as the issue of Glass-Steagall.

Now secondly, the chairman talked about the difference between markets and institutions and I don't think that that is often well appreciated in terms of the competitive structure of the world.

For example, there is much comment made with respect to Japan and the restrictive practices within Japan as it affects non-domestic—meaning non-Japanese—financial intermediaries. If you look at their laws, you will see quite clearly that on an institutional basis there is no discrimination. That is, a U.S. securities firm can do whatever a Japanese securities firm can do. And that a U.S. or foreign commercial bank can do whatever it is that a Japanese commercial bank can do.

But their restrictions are in market practices and market regulation, not in institutional regulation. Therefore, to deal with that kind of issue, it is clearly important to distinguish discrimination de facto and de jure.

Let me give an example. In the securities industry, the question of underwriting Japanese government bonds, which has been fully discussed in the Senate, so there is no point in repeating the history, but clearly there was an allocation system which discriminated against non-Japanese houses.

In the commercial banking system, the Japanese authorities permit U. S. commercial banks to do what Japanese banks can do, but since they have not had short-term money market, the only way a non-domestic institution could raise liabilities to match its asset portfolio would have normally been through money markets. Since a short-term money market did not exist, and the only other way to fund liabilities was to build deposit-taking branches, an incredibly expensive undertaking.

Finally, the question of international cooperation, which I've commented on quite extensively in my prepared testimony, is more important than I think we realize. The problem today, as the chairman has pointed out and the testimony of my colleagues at the witness table have also noted, is that the world in which we live is incredibly different from that at the time most of the laws regulating financial institutions and financial markets were originally conceived.

There is much talk, for example, as to which market is the dominant market. Before World War I, it was London. After World War I, it was New York. And now if the present trends continue, then it may be Tokyo.

In fact, the dominating market is really the satellite in the sky. The dominant market-place is the one that's open in the 24-hour global system, so that at a certain time Tokyo is dominant, then London is dominant, and then New York.

So if you live in a world in which market regulation and geographic area is no longer the critical factor because of technology and data processing and communications and all that, then the dominating factors become the institutions which spread themselves across the markets and operate in full force, 24 hours a day. Therefore, the whole system of supervision, regulation, standardization, becomes more important on an international basis than on a national basis because the national interest in regulation has become more and more subservient to global activity.

It becomes of importance to think through conceptually what we mean by international harmonization, standard-setting, what are the roles of the public and the private sector, and then to reach an accommodation between the major nations of the world as to how that would be effectuated. Thank you very much.

[A summary and complete prepared statement of John D. Heimann follows:]

SUMMARY STATEMENT OF

JOHN G. HEIMANN,
VICE CHAIRMAN
MERRILL LYNCH CAPITAL MARKETS

BEFORE THE
SUBCOMMITTEE ON SECURITIES OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

HEARING ON GLOBALIZATION OF THE
SECURITIES MARKETS

JUNE 14, 1989

Chairman Dodd and Members of the Subcommittee:

My name is John G. Heimann, Vice Chairman of Merrill Lynch Capital Markets. I am honored and privileged to have been asked to appear before this Committee and to present some thoughts on the globalization of the securities markets. Your letter of invitation raised a number of questions which I have commented upon in my full statement in the order presented. My oral presentation is a summary of my statement, which I request be included in the record.

We have reached the point in history at which the traditional divisions between domestic and international policies are fast becoming anachronistic. We are living through a period of revolutionary change in the provision of financial services. Deregulation--the opening up of national financial markets to international competition and the abolition of exchange controls and other restrictions--is sweeping the globe. Free market principles are being embraced by countries as different in outlook and development as France and Chile, Canada and the Soviet Union, bringing in their wake a broad variety of liberalization measures. A new phase of market capitalism--global, rather than national--has been irreversibly established.

Wherever we look, we can see the powerful effect of the globalization of capital on the world's economy. The pace of growth in international money flows is nothing short of astonishing. Last year, a staggering $10 trillion of securitized funds moved across national frontiers. Global financial transactions currently amount to a historically high multiple of the volume of world trade. Foreign exchange transations alone are approximately $350 billion a day. It is clearly the movement of capital--not trade--that is driving the economic and financial world.

The most beneficial by-products of the changes are product innovation and competition. These two, of course, are interlinked. In recent years, investors and issuers have been presented with a mind-boggling array of new products and services offering more opportunities and greater flexibility at a lower cost than ever before. Behind the innovations has been the transforming power of computer and information technologies. They have been responsible for the proliferation of a whole new generation of securitized products. These new instruments cover a wide range, from short-term notes to perpetuals, floating rate and fixed interest, equities and convertibles.

Issuers and investors have been confronted not only with a greater choice of products, they have also been faced with a proliferation of financial intermediaries competing for their business. Deregulation has opened up markets by increasing the number of competitors, both foreign and domestic, and the boundaries between commercial and investment banks have become increasingly blurred. In the United States and Japan, where the Glass-Steagall Act and Article 65 respectively have historically segregated the activities of commercial and investment banking, participants have increasingly found ways to work around the restrictions. They have done so partly through innovative new products and partly through legal and administrative loopholes.

Merrill Lynch, for example, developed its Cash Management Account which capitalized on anachronistic regulatory restrictions on bank deposits. Both U.S. and Japanese commercial banks have been able to take advantage of rules that permit ownership of foreign securities affiliates.

The blurring of traditional boundaries, of course, is more complex. Increasingly, issuers who were used to obtaining financing through commercial banks, have been able to gain direct access to the capital markets. One result has been the explosive growth in the U.S. and Euro Commercial paper markets which are now measured in hundreds of billions of dollars. These companies now tap the credit markets, often on better terms than the banks themselves, resulting in the disintermediation of the commercial banking system.

In sum, the financial system of the world is becoming increasingly globalized. Due to the forces of technology, the institutionalization of savings, the liberalization of nationally imposed restrictions, and, perhaps most importantly, the demands of the users of the system, no longer is one nation dominant. We have succeeded in creating an integrated and interrelated financial world in which all have much the same at stake. The dream of "one world" has become, at least in the financial sense, a vital reality.

The increasing globalization of financial markets and institutions and the increasing blurring of traditional distinctions between different types of financial institutions have raised growing concerns about the appropriateness and viability of the existing regulatory framework of the financial services industry. Individual countries have begun to address this issue on their own. And the risk-based capital guidelines recently adopted by the Basle Committee are a clear effort at international harmonization of one aspect of regulations affecting commercial banks operating in different countries.

We need to develop a general conceptual framework defining the basic purpose of and need for regulation of financial institutions, and what types of harmonization across institutions and countries are desirable. It should take fully into account recent and prospective changes in technology affecting financial markets and institutions, as well as the trends toward the globalization of the markets and institutions, the securitization of financial products, and the increasing similarities between traditionally different types of institutions.

In particular, we should address the issue of whether there should be any attempt at all at harmonization of regulations either across different types of institutions or across countries. If harmonization is to be sought, should each area of regulation be addressed independently, regardless of the harmony or disharmony that exists in other areas? Alternatively, should variations deliberately be introduced or allowed to remain in one area of regulation in order to "compensate" for lack of harmony in other areas and thereby attempt to achieve some sort of net overall balance?

Speaking to your question on the consequences of a declining role for American financial institutions to our economic and national security interests, it is self-evident from history that strength in this realm is the ultimate bastion of national potency. We simply cannot afford to allow this to happen, and we must be prepared to take the measures necessary to ensure that it will not happen.

Here it is important to draw a distinction between considerations affecting the strength and soundness of our financial institutions, per se, and considerations concerning our competitiveness in international markets.

I think it is clear from the competitive point of view that American firms are today the leaders in global finance and possess the know-how to maintain this leadership. We are already well-established and accepted in the world's most important markets, so we are not likely to lose position because of technical or marketing weaknesses.

However, the market structure we impose on ourselves through U.S. regulation could constrain us in the future as we are faced with increasing competition (even in our home market) from institutions that operate under less restrictive national or regional regulation. Europe as a whole is moving toward universal banking; Canada has already adopted this principle and Japan is experimenting with modifications to Article 65. Firms which operate under these broader powers in their home markets have a much bigger resource base from which to fund their international expansion than American firms may have three years from now if we maintain our current market structure.

Finally, the relative strength of our financial services industry will be in large part determined by much broader national policy considerations. Our stance vis-à-vis the development of Eastern Europe on one side and Asian countries on the other, will greatly influence the participation of our financial institutions in the resulting flows of funds. We run the risk that if we are too "laid back" about these developments, Germany and Japan will seize the initiative in these new markets and leave us isolated.

STATEMENT OF

JOHN G. HEIMANN,
VICE CHAIRMAN
MERRILL LYNCH CAPITAL MARKETS

BEFORE THE
SUBCOMMITTEE ON SECURITIES OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

HEARING ON GLOBALIZATION OF THE
SECURITIES MARKETS

JUNE 14, 1989

Chairman Dodd and Members of the Subcommittee:

My name is John G. Heimann, Vice Chairman of Merrill Lynch Capital Markets. I am honored and privileged to have been asked to appear before this Committee and to present some thoughts on the globalization of the securities markets. Your letter of invitation raised a number of questions which I have commented upon in the order presented. My oral presentation is a summary of my submission which I request be included in the record.

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Issuers and investors have been confronted not only with a greater choice of products, they have also been faced with a proliferation of financial intermediaries competing for their business. Deregulation has opened up markets by increasing the number of competitors, both foreign and domestic, and the boundaries between commercial and investment banks have become increasingly blurred. In the United States and Japan, where the Glass-Steagall Act and Article 65 respectively have historically segregated the activities of commercial and investment banking, participants have increasingly found ways to work around the restrictions. They have done so partly through innovative new products and partly through legal and administrative loopholes.

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In sum, the financial system of the world is becoming increasingly globalized. Due to the forces of technology, the institutionalization of savings, the liberalization of nationally imposed restrictions, and, perhaps most importantly, the demands of the users of the system, no longer is one nation dominant. We have succeeded in creating an integrated an interrelated financial world in which all have much the same at stake. The dream of "one world" has become, at least in the financial sense, a vital reality.

First, what is the extent of international securities trading activity at this time, and what are the trends? Do you foresee a global, 24-hour trading market for securities and other financial instruments? What is the current role of the U.S. in the international securities markets, and what is the comparative role of other major financial centers, such as London and Japan? What are the general trends in the nature of investors and market participants (for example, institutional investors compared with individuals; diversified financial services companies compared with more specialized firms)?...[Provide] your unique perspective and judgment about where the markets are going and what the markets of the future will look like.

International securities trading is now a well-established trend, not a cyclical event or a temporary fashion, particularly in foreign exchange and its closest surrogate, fixed income securities. This trend follows the rate of development in facilitating technologies, is encouraged by the liberalization of foreign exchange controls around the world and is stimulated by broad and rapid dissemination of economic and financial information through all the public media. Perhaps most obviously, it is a necessary mechanism in the funding of governments such as our own.

Besides foreign exchange, government issued debt is the most globally traded category of securities and all major capital markets firms now "pass the book" around the world's time zones and make markets in these securities on a continuous basis. Related derivative markets follow accordingly so that futures and options exchanges are now establishing electronic links amongst themselves around the world. Equity markets, more susceptible to cyclicality, remain somewhat regionalized but, nonetheless, are also increasingly globalized.

U.S. firms have led the way in the evolution of global trading and remain today the most fully globalized players. In general, they are the most internationalized, having established full scale operations in all three legs of the triad time zones and, as distinct from the Japanese, have a more internationalized clientele. Moreover, Americans are still regarded as the leaders in trading and risk management techniques.

London is the focal center of the global financial market for two key reasons: (1) it bridges the 24-hour clock so that live interaction is possible with Tokyo in the morning and with New York in the afternoon and (2) the British government has taken forceful measures to ensure that London is a desirable place to do business.

The importance of Tokyo, on the other hand, is derived from Japan's role as the world's leading creditor nation. It is not, by any means, a rival to London or New York as an international marketplace.

The international securities markets are largely focused on institutional investors: insurance companies, supra-nationals, central banks, commercial banks, and asset managers--the latter often representing individual investors--and to a much lesser extent, direct investments by individuals. This is consistent with a universal trend toward the "institutionalization" of assets (e.g., The Wall Street Journal reported in March of this year on a Securities Industry Association study showing that only 18.2% of NYSE Volume was done by small investors).

Both performance and complexity account for this trend: statistically small investors seldom out-perform funds and the growing complexity of products and markets encourages small investors to put their money with professional managers.

As for the types of firms that participate most actively in international trading, diversified financial firms (banks, full service broker/dealers) are the dominant players, firstly because of the scale of resources required: capital, depth of skills, geographic coverage, and operational infrastructure. Secondly, this concentration of business in the hands of very large firms is driven by the progressive commoditization of the products involved; very large volumes are necessary to achieve profitability under the condition of narrowing margins.

None of the patterns described so far are likly to be reversed and furthermore, because these are convergent trends, they will continue to reinforce each other.

Thus, I foresee an increasingly globalized, institutionalized, and competitive environment for securities trading in the future. I expect further consolidation to occur on an international plane as leading American, European, and Japanese firms strengthen their multi-national capabilities. Nationality of firms will become less important and success will depend increasingly on the relative financial strength and skills of individual firms, regardless of their home country.

Second, what is your assessment of the soundness, strength and efficiency of current market mechanisms, such as clearance and settlement systems? How well do our markets "work" from a technical standpoint? Are there risks in the market system itself? We are aware of the Group of Thirty report, but we would appreciate your guidance as to what the U.S. Congress and other governments should be doing in this area versus what the private sector can do on its own. How can government help or assist these private sector initiatives? [Note: The second set of questions will be discussed later as part of the answers to questions 3 and 4).

You are aware of the Group of Thirty Report which is essentially a set of the recommendations to improve the strength and efficiency of clearance settlements systems. Committees have been formed in all of the major countries to implement the set of recommendations. In many respects, the suggested changes do not require direct government assistance. Nevertheless, as the U.S. Committee proceeds with its deliberations, it may well conclude that governmental assistance is needed and, if that is the case, then I would urge the Congress, after proper evaluation, to help in their implementation. The Goup of Thirty Report presents for consideration a series of interrelated problems which, if solved along the lines suggested, will provide for a far more efficient and safe settlement and clearing system.

Third, what is the role of multiservice, multinational financial services firms, and how effective is the financial supervisory structure overseeing those firms? Is there sufficient regulatory coordination and information sharing in this area? And, how do you balance adequate supervision and regulation with competitive concerns?

Fourth, in international markets, what should we expect in terms of financial reporting and disclosure standards? What are the appropriate disclosure and distribution standards applicable to international securities issuances?

[Continued from the second question] **As part of this set of issues, what is your opinion of the current status of international regulatory co-ordination and crisis management? Here is an area where most would agree that government must play a role, but what is that role, and what should government be doing now with the private sector to define that role?**

The increasing globalization of financial markets and institutions and the increasing blurring of traditional distinctions between different types of financial institutions have raised growing concerns about the appropriateness and viability of the existing regulatory framework of the financial services industry. Individual countries have begun to address this issue on their own. And the risk-based capital guidelines recently adopted by the Basle Committee are a clear effort at international harmonization of one aspect of regulations affecting commercial banks operating in different countries.

The efforts undertaken to date to reform the regulatory structure of the financial services industry raise several issues.

First, all the initiative so far has come only from the regulators. While the private sector has been consulted, its input has been only in the form of reaction to regulatory proposals. The private institutions most affected by regulation could make a better contribution if they first develop their own comprehensive view of what the most appropriate form of regulation should be within and across countries.

Second, virtually all of the attention so far has focused on commercial banking. No systematic attempts have been made to harmonize any regulation of other financial services institutions that offer the same types of products as commercial banks. Indeed, as noted in the various studies of the stock market crash of October 1987, there is not even a mechanism to review the regulation of non-banking institutions on an international basis similar to the work of the Basle Committee. Efforts to broaden the scope of regulatory review beyond commercial banking clearly are needed.

Third, even within the body of regulations that affect commercial banking, the capital guidelines that have now been developed by the Basle Committee are only one part of the overall total. Differences between countries in the fiscal treatment and accounting presentation for tax purposes of certain classes of provisions for losses and of capital reserves derived from retained earnings may to some extent distort the comparability of the real or apparent capital positions of international banks.

We need to develop a general conceptual framework defining the basic purpose of and need for regulation of financial institutions, and what types of harmonization across institutions and countries are desirable. It should take fully into account recent and prospective changes in technology affecting financial markets and institutions, as well as the trends toward the globalization of the markets and institutions, the securitization of financial products, and the increasing similarities between traditionally different types of institutions.

In particular, we should address the issue of whether there should be any attempt at all at harmonization of regulations either across different types of institutions or across countries. If harmonization is to be sought, should each area of regulation be addressed independently, regardless of the harmony or disharmony that exists in other areas? Alternatively, should variations deliberately be introduced or allowed to remain in one area of regulation in order to "compensate" for lack of harmony in other areas and thereby attempt to achieve some sort of net overall balance?

For example, should a country such as Germany, with relatively little restriction on the types of activities that may be undertaken in commercial banks, offset this greater freedom by imposing relatively high capital requirements on its banking institutions? Or in the United States, does the requirement for "firewalls" separating banking from non-banking activities within a single holding company justify easing captial requirements or some other regulation? Or if any brokerage activities conducted by commercial banks are subjected to international regulation, should similar regulations be established over brokerage activities in non-banking insitutions?

This conceptual framework should then be used as a criterion for examining the many differences that exist in the financial structure and regulations of the major countries.

The work of the Basle Committee on capital guidelines for commercial banking is, of course, one of the specific regulatory areas that should be included in any overview. But the overall scope should be much broader than just capital. Other obvious and important differences exist in the basic financial structure within different countries, in the general and regulatory accounting rules that apply to different institutions in the various countries, and in the tax treatment of different institutions. Each of these areas requires detailed analysis of the specific differences that prevail, and analysis of how they fit into the overall regulatory context to limit or enhance the soundness and competitive ability of the affected institutions.

Differences in the basic financial structure within countries are one of the most significant areas that need to be documented. These include, in particular, differences in the ownership structure of banks in different countries and in the range of activities allowed within banking institutions in different countries. Related to these issues are the differences in requirements for firewalls to separate one activity from another within the same organization, such as exist particularly in the context of bank holding companies in the United States.

Another key area of structural differences involves the types of deposit and/or brokerage insurance systems that exist in different countries. In many countries, such systems are only implicit and informal, while in some--particularly the United States--they are explicit and formal. Some financial institutions also have much closer ties than others to their country's government and, in particular, to the lender of last resort role of their nation's central bank.

These and other structural differences obviously reflect basic cultural differences among countries as well as long-standing traditions surrounding the development of particular types of financial institutions. But in today's global economic climate, they also clearly create at least potential advantages and disadvantages for some financial institutions compared with others both within and across countries. These advantages and disadvantages need to be more fully and systematically documented and understood than is presently the case.

Within the accounting area, one of the most important differences among countries and institutions involves the degree and type of consolidation of affiliates required in either public or regulatory reporting. Given the differences in consolidation requirements, even succesful attempts to harmonize regulatory treatment such as capital standards for parent companies may well leave affiliated entities in different institutions or countries in very different regulatory circumstances.

Bank regulators in most countries have moved in recent years to require at least some degree of consolidation in the financial statements of the institutions they regulate. But some countries require full consolidation while others use pro-rata consolidation. Also in some countries, consolidated treatment is required for banking subsidiaries where ownership is as little as 20%, while in other countries it may be only for those involving more than 50% ownership. Banks' published financial statements, on the other hand, in many countries are not required to incorporate the overall organization. And non-banking financial firms often do not face any requirements for either public or regulatory reporting.

In the tax area, in addition to the significant differences that exist in the treatment of loan loss reserves, several other differences are also important. In particular, there are wide differences among countries in whether they tax companies within their boundaries on a worldwide or a territorial basis, and on the determination of what constitutes fiscal residency. These can be further complicated by differences in the tax treatment of asset transfers and of the effects of currency fluctuations. The net effect is that in some cases it becomes almost impossible for a company to avoid double taxation of the same income by different taxing jurisdictions, while in others it is at least conceptually possible to avoid taxation altogether. The competitive advantages and disadvantages created by these differences in tax treatment often swamp other regulatory differences.

Seventh...we would appreciate your views on the competitiveness of the U.S. financial services industry and our securities markets relative to other markets. What do you see as significant barriers to entry in other major markets, and what should be the role of Congress, U.S. financial regulators and the Executive Branch in addressing them? What do you view as the potential consequences to U.S. economic and national security interests if our financial services firms and securities markets lose what many have viewed as their historical dominance?

The question of competitiveness of the U.S. financial services industry and our securities markets relative to others needs to be broken down into its various parts in order to be understood clearly and acted upon rationally.

First, there is the matter of competitive strength and soundness of our financial institutions as these are affected by our own laws and regulations. This in turn, has two aspects:

- •those issues created by Glass-Steagall
- •those attendant to interstate banking restrictions.

Second, there is the question of competitiveness in international markets, most significantly in Europe, against European institutions, and in Japan.

As you all know, there are opposing views (characterized by the Securities Industry Association on the one hand, and the American Bankers Association on the other) as to the desirability of maintaining the Glass-Steagall Act. The Congress has heard extensive testimony on this question so there is no need to repeat it here except to point out that:

- The subject is moot within the European Community as American banks and securities firms are free to act according to local regulation in Europe (i.e., Merrill Lynch can be a bank and Citicorp can be a securities firm in most European countries today).

The question of reciprocity vis-à-vis the European Community now appears to be a red herring as the announced EC policy is now "national treatment". But, Europeans have a point when they draw a negative comparison between our interstate banking laws and the agreed harmonization of banking rules across Europe in 1993, i.e., it will then be more difficult and more expensive for a European bank to operate in the U.S. (multi-state) than in Europe (multi-country) regardless of Glass-Steagall.

There is a tendency to roll everything up into a ball of wax called "1992" and thus; (a) to confuse, (b) to confound, (c) to procrastinate and thereby, not to recognize where we may be more of a "fortress" than Europe is likely to become.

As to the competitive opportunities available to American firms in Europe after "1992", we agree in general with the London Business School Centre for Strategic Studies when it points out that:

> In the retailing of financial services, any (potential) economies of scale appear to be outweighed by economies from local specialization, and in wholesale banking, most economies that exist have already been exploited.*

That is to say, 1992 is not likely to bring about major changes, as the wholesale market is already relatively free (except in countries which maintain exchange controls and in those which impose de facto barriers, i.e., Germany). In this context, U.S. firms--like Merrill Lynch--can and will be able to do virtually anything they wish to do and anything that European firms can do.

London is likely to remain the international financial center of Europe in the global sense. There are many practical reasons for this that include (a) inertia--that is, where people have put down their international stakes and therefore will be reluctant to pick up and move them elsewhere, (b) a lower corporate tax rate than elsewhere in Europe, (c) the English-speaking environment--considerable hidden cost advantage to all, as English is the *lingua franca* of finance, and (d) a well-established infrastructure of financial institutions and intermediaries.

However, London may not turn out to be the center of the European market, in part due to the relative weight of Sterling in the ECU and in part due to Mrs. Thatcher's position vis-à-vis EMS. This is an aspect of 1992 that should be vigilantly watched by both U.S. institutions and our government.

Let me digress here briefly to contrast the challenge presented to us by 1992 in Europe with the situation in Japan. In Europe, we are looking principally at *de jure* changes in the structure of a marketplace whereas, in Japan, many of the barriers we face are *de facto*, not *de jure*. Cultural barriers are very difficult and, at best, very slow to yield to negotiation and this is the condition we are faced with in Tokyo. In Europe, however--with the possible exceptions of Germany--the cultural barriers to American firms are limited and weakening so that the challenge before us can yield to national and balanced negotiation. The actions we need to take in reciprocity for what we wish to gain in Europe are, and will remain, clear and recognizable , even if not easily effected. It is important that we recognize that, with respect to the European Community, we are operating in the realm of free choice.

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* London Business School Centre for Strategic Studies publication "1992: Myths & Realities", page 91. [Emphasis added]

The most potentially troublesome barriers to free competition for U.S. financial institutions in post-1992 Europe lie not so much in the realm of banking and securities direcitves as in other fields which could directly affect relative operating costs and therefore, tilt the playing field in favor of local companies. Most of these are still being heavily debated and I refer in particular to those relating to procurement and telecommunications. These are described in some detail in the Business Round Table Statement of February 1989*, and we support their recommendation that the Executive Branch and Congress be vigilant on this front as well. But it is also imperative that on all these issues we examine ourselves closely before making demands in Brussels. We cannot negotiate very effectively for openness in Europe when we are not equally prepared to be open ourselves.

Speaking to your question on the consequences of a declining role for American financial institutions to our economic and national security interests, it is self-evident from history that strength in this realm is the ultimate bastion of national potency. We simply cannot afford to allow this to happen, and we must be prepared to take the measures necessary to ensure that it will not happen.

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* The United States and the European communities single market initiative: an Analytical Framework.

Senator Dodd. That's very, very helpful. I should have noted for the record that John Heimann was the Comptroller of the Currency and I want to thank you. Your testimony I find very creative and interesting. I think your last point as well is one that's very fascinating. There's a tendency to say who's dominant and you pointed out that eye in the sky is really the dominant factor. It's a very good point.

Bob, we thank you for being with us this morning.

STATEMENT OF ROBERT D. HORMATS, VICE CHAIRMAN, GOLDMAN SACHS INTERNATIONAL, NEW YORK, NY

Mr. Hormats. Thank you, Mr. Chairman.

I would just like to comment on a few points and particularly to follow up your question about the competitiveness of our industry and what might be done to strengthen that competitiveness as we go along, and also to avoid the risks inherent in a much more intense set of international trading arrangements.

The first point, and one you've mentioned in your introduction, relates to the whole question of a very vigorous market in cross-listings and an increasing move toward multi-time zone, after-hours trading. This move is by and large healthy. It's going at a relatively rapid clip. It started out largely in U.S. Treasuries and in currencies, but it's going to include foreign bonds of other countries, corporate stocks and bonds, and derivative products, the hedging products that we utilize because people want to be able to hedge in various time zones.

One point we need to bear in mind is that we are losing the "cross-listing race," so to speak. That is to say, there are a lot more foreign stocks today being listed in London and Tokyo than in the United States; that is in part because we have a somewhat more rigid set of listing requirements and disclosure requirements in our market than others do.

Now obviously one doesn't want to eliminate disclosure requirements, but it needs to be borne in mind as we go along that we're not operating in a vacuum. To the extent more American stocks go abroad and are traded abroad, the tendency in part is for other securities firms in other countries to get a larger chunk of that action.

Then there is also what I refer to as "regulatory arbitrage." That is to say, you move from the more regulated to the less regulated markets. This is an issue the European Community is going to have to deal with as it establishes its 1992 Single Market. There is a risk—and the British perceive this risk—that firms that feel regulations in Britain are too stringent will put their headquarters somewhere on the continent where the regulations are not quite as onerous. The same could be true with listings, i.e., that you would list in a market where you don't have quite the same degree of restrictiveness.

This is not to say we should change dramatically or others should change dramatically. It means that we have to find a way of harmonizing listing requirements globally because we don't want stocks to go, or firms to go, into areas where regulation is lax. That simply undermines the international effort to ensure reasonable regulatory standards. So some degree of harmonization is required to avoid this move toward the most permissive type of environment.

With respect to the settlements and the clearance procedure, I perceive this to be—as I believe the Brady Commission did—a major risk. It's a major risk in the United States. The system chocked up during the Crash in October 1987. Now we have increasing amounts of international trade in countries where the clearance and settlement system is far weaker than our own. In some cases it takes you three or four weeks to get the shares that you bought and the float, as Alan Greenspan put it, is very long in many of these countries. The longer the float, the greater the risk. In a system that's highly integrated, these long float periods, and the awkwardness of clearance and settlements in foreign markets, is a direct threat not just to their markets but to our own.

The chairmen of the various securities groups around the world, the IOSC, have been discussing this. But I think it would be well to encourage them to try to focus to a greater degree on the subject and to try to make more progress. This may well be—I think probably is—the Achilles heel of the system. This clearance and settlements process is very complicated.

If something is done it should be done on the basis of a public-private committee of experts, because the private sector really knows more about it than government officials. They have to live in this complicated world every day and, therefore, if you could get a G-10 or G-7 group to sit down and examine this with the private sector participants and the government people—and there's precedent for this—it would be a good idea.

Also on the question of regulatory standards, there are major differences in accounting, auditing, disclosure, and registration standards. The European Community is having to address this as it deals with 1992 to develop some minimum standards and then, once they do that, to recognize one another's practices. It seems to me that in parallel with that it would be a good idea for the Group of Seven, perhaps at the summit, to launch a similar exercise so we don't have Europe proceeding on one course and Japan and the United States, Canada and others proceeding on another. Some greater degree of harmonization, and a greater degree of mutual recognition of disclosure requirements, strikes me as an interesting concept to pursue and something that can be done with relatively little difficulty if the institutional structure is there.

The letter of invitation also raised an issue which I found particularly interesting and which was touched on earlier, and that is the question of foreign investment in the United States, particularly direct investment.

It does strike me that this is where the savings issue is particularly important. That is to say, we have a big shortfall in the U.S. between the amount we save and the amount we invest. The shortfall is made up with money from abroad, $120 to $140 billion. And whether we like it or not, unless we raise our savings rate, that money is going to come in—a net flow of that amount.

There are all sorts of concerns about whether we should have a review process. My own judgment is that antitrust laws and the security review provisions of the Pentagon basically deal with most of the concerns except for the emotional concern, which is high in some quarters. But, there's going to be a political problem that will probably fall in the laps of the Congress and the Executive Branch. That is, the Europeans are going to have an EC review process in Brussels. It's not fully decided what it will be, but there will be one. Canada, fortunately for Canada and for everyone else, has eliminated its FIRA, Foreign Investment Review Agency, but has a review process which is a much more modest version of what they had. The Japanese—again, John's point is apt on Japan—it's very hard to buy a Japanese company if you want to buy one, not because there's anything in the law that says you can't do it, but give it a try and you find out that it's not so easy to do.

Senator DODD. Boone Pickens says it's even hard to get on the board, even if you own 20 percent of it.

Mr. HORMATS. You can't get on the board even if you own 20 percent of it.

Senator DODD. He ought to talk to the Ford family.

Mr. HORMATS. Even if economists can say foreign investment is good for our health—politically there's going to be a problem if other markets are more restrictive than our own. At some point we are going to have to engage in a much more active international dialogue to set basic standards of openness, not only on the issue of direct investment but also on the related issue of local content requirement, which also has an impact on investment.

The last point relates to Europe and Japan. The European Commission, thanks largely to Sir Leon Britton and his colleagues, have modified the notion of "mirror image reciprocity" and now have what can be called conditional national treatment provisions in the Second Banking Directive.

That directive still hasn't gone through the whole approval process and it still has to go to the European Parliament; and the European Parliament has taken a tougher attitude on that than the Commission. And they are having elections now; it is possible that the European Parliament, could stop the process or change it somewhat. We still have to be vigilant on that point.

We also have to be vigilant on the point of capital requirements for securities firms, to make sure that they are not instituted in such a way that they put securities firms at a disadvantage vis-a-vis the banks.

And the point on Japan is an interesting one. The Japanese market, in terms of the size of the market, is really the premiere global market in many areas.

In part due to the Ministry of Finance-Treasury Yen-Dollar talks, which have gone on for a number of years, a good deal of progress has been made in opening up the Japanese Market; and the Japanese have created a lot of new markets in the firmest products as they liberalize their domestic system. But there is room I believe for improvement in opening the process of consultations to foreign firms. The Big Four in Japan tend to dominate the consultation process, not only with the government but also with the Tokyo Stock Exchange and the various securities agencies. I think it's particularly important that the foreign firms in Japan be brought in more actively to the consultative process as the rules and practices are developed. If that doesn't happen, then all the progress that's been made by the Japanese—and indeed I want to point out that the Japanese have made a lot of progress—could be observed. On the other hand, if they can move ahead on the consultative side, that would be a further step in the right direction. Finally, elimination of the restraints on foreign exchange trading by securities firms would be a big addition to the openness in Japan. Foreign exchange cannot be traded by securities firms there and that makes it very difficult to hedge yourself in yen, and it complicates trading in a lot of other areas.

So there is room for improvement, but I say again the Japanese have made a lot of progress and we think, by and large, that the playing field is becoming more level around the world. But he have to be vigilant because it can always tilt back.

Thank you.

[The complete prepared statement of Robert D. Hormats follows:]

Testimony of Robert D. Hormats
Vice Chairman, Goldman Sachs International

Before the Subcommittee on Securities
Senate Committee on Banking, Housing and Urban Affairs
June 14, 1989

I am pleased to have the opportunity to testify before you today on the subject of the globalization of securities markets.

You have posed, in your letter of invitation, a series of penetrating questions -- which together underscore the complexities of international securities markets and the enormous changes they have undergone. I would like to begin answering these questions by highlighting four sets of changes which have shaped the development of the global securities markets over the past few years and then respond to a number of the specific questions you have posed.

FOUR MAJOR CHANGES IN THE 1980'S

Four major changes have had a dramatic impact on securities markets during the current decade:

-- DEREGULATION. The last few years have seen a remarkable relaxation of heretofore rigid national controls on financial markets. The primary reason for this relaxation has been the recognition by governments that highly regulated financial markets were incompatible with dynamic economies, and that indeed excessive regulation could seriously impede the efforts of business to compete in international markets by denying it low cost and liquid forms of financing, and vehicles for laying off risk. First to fall in most cases were exchange controls, then ceilings on interest rates, then constraints on the presence of foreigners in domestic financial markets, and then excessive regimentation of domestic financial institutions. All this gave buyers of securities a wider set of domestic and international choices, sellers of securities a broader range of market opportunities, and those who sought to reduce risk a broader scope for doing so.

-- INSTITUTIONALIZATION. A striking change in markets over recent years, particularly the U.S., has been the increase in the role of institutions, as opposed to individuals, as market players. Today institutions account for roughly 80% of securities trading. This has occasioned the use of such trading vehicles as the S&P 500 index, and other derivative securities, as hedging devices; they are used by these institutions because hedging in very large amounts of a single stock could be disruptive to the market, and because large hedging vehicles are necessary in light of the large stock positions they hold. In addition, in order to diversify risk internationally, and seize new opportunities in growing economies, as well as to take positions in foreign companies in strong industries, institutions have turned to offshore investment. Japanese insurance companies are specifically encouraged to invest abroad so that they would not have too great a portion of their assets tied up in Japan, and thus could meet the large claims that would arise were an earthquake to hit Japan and destroy large segments of domestic industry. Institutions have also found it easier to do the research needed to make judgments among offshore stocks than have individuals.

-- MARKET VOLATILITY. Market volatility has spawned a wide range of hedging devices such as currency swaps, interest rate swaps, options and futures. Increased volatility combined with eased cross-border trading has raised the risk of currency losses and thus encouraged further efforts at portfolio diversification. It also means that investors want to find ways to adjust their holdings of foreign securities not simply when foreign markets which normally trade those securities are open but also when their own domestic markets are open; and this is an important factor encouraging the cross listing of securities in major international markets and twenty-four hour trading in securities -- and thus similar types of arrangements for trading financial futures and options.

-- TECHNOLOGICAL INNOVATION. In parallel with, and supportive, of this surge of financial innovation is a technological explosion made possible by links between computerization of the industry and the possibilities for instant transmission of news, data and trades. This in turn has been a source of market volatility; but it has given rise to a range of new hedging devises to manage the risks exposed by that volatility. And it has contributed mightily to the internationalization of securities markets.

Turning now to your specific sets of questions, let me address those subjects where I feel I can make a useful contribution. Confident that others have a greater comparative advantage than I on some of the issues raised, I shall leave those to more expert minds than my own.

-- TWENTY-FOUR HOUR TRADING. There is a strong and unmistakable trend towards the extension of trading hours. Already the Philadelphia exchange trades currency options starting at 4:30 a.m. and goes to 10:00 p.m. on most days, with some breaks. In the fall, the Chicago Mercantile Exchange will open its GLOBEX system, in conjunction with the New York Mercantile Exchange, and French MATIF, and the Sydney Futures Exchange to trade currency futures and options, Eurodollar futures and options and Treasury bill futures and options from 6:00 p.m. to 6:00 a.m. The London International Financial Futures Exchange (LIFFE) plans similar types of activity. The CBOT also has off-hours trading of U.S. Treasury Note and Bond futures, as well as silver and gold futures. And NASDAQ will soon start trading at 4:00 a.m., enabling it to trade throughout the London day and compete with London in dual listed shares; London now quotes about 350 NASDAQ shares on its SEAQ quotation network (which is similar to NASDAQ).

The trend toward longer houses is, as noted above, in response to a direct need. Institutional investors, in particular, must constantly reevaluate their risks and hedge them, adjust their portfolios, and executive orders in a timely way. Much of the extended hours activity now taking place is in the area of U.S. Treasuries -- largely because they are highly liquid and highly secure, and there is a global market in this paper. They are traded in most major financial markets around the world. Virtually 24-hour trading is taking place in these instruments. And this has given rise to demand for after hours trading in instruments to hedge them. For obvious reasons, there is also around the clock currency trading, and thus round the clock hedging.

It appears to be only a matter of time until other types of securities -- foreign government bonds, corporate bonds of large companies, and stocks of major companies become actively traded on a twenty-four hour basis. For example, as of November 30, 1988, 90 companies were listed on both the Tokyo and New York Stock Exchanges; ten of these were among the "20 Most Actively Traded" list of the NYSE. In the case of London, 181 U.S. companies were listed on both ISE and the NYSE, which accounted for over 40 percent of the NYSE market -- with 19 U.K. companies on the NYSE. The 181 figure included 13 companies on the "20 Most Actively Traded List." It appears today off-hours trading in NYSE shares amounts to about 10% of its daily volume; and the exchange is considering whether it should offer off-hour service itself. Most major U.S. securities houses are members of the TSE and London ISE, thus facilitating the nearly round the clock trading of major stocks. As trading activity in these shares grows, there will be greater demand for instruments to hedge in the time zones in which the trading of the stock is taking place.

It is worth mentioning at this point that we in the U.S. must take care that we do not make listing requirements so onerous that we discourage foreign firms from listing here, while American and other firms list in other markets abroad outside of their home country, lest increased trading activity go to foreign markets at our expense. That would weaken our exchanges, and our securities companies; and these stocks would also escape the reach of American regulatory authorities. In this age of technology, there may be temptations among U.S. companies to list on foreign markets where it is easiest to do so, knowing that Americans can trade in the stock with increasing ease even if it is listed on the ISE, ngapore, Sydney or Toronto -- and that new hedging instruments for U.S. shares in those markets are likely. The rate of new foreign stock listings is, in fact, growing far more rapidly in Tokyo and London than in New York. In 1987 there were 16 new foreign listings on the NYSE, and through the third quarter of 1988, only 6 new listings. For the TSE comparable figures were 36 and 65; and for the ISE, 34 and 27.

Cross-border listings are likely to grow, especially in Western Europe. The Chairman of the 1992 Committee of the International Stock Exchange in London, Stephen Raven, has suggested a plan whereby 100 to 150 top European companies would be quoted in ECUs through a screen-based trading system, which would be available to market makers throughout Western Europe. It might also include non-European stocks with a major following. There could also be an index of the top 100 European stocks quoted in ECUs to form the basis for new markets in futures and options trading. Other proposals would link the various European markets together, thereby allowing brokers to compare prices in different financial centers and then make a choice on behalf of a client.

It should be noted that London stands to benefit from much of the internationalization of trading in Europe and globally. In 1988, for instance, secondary trading there in French stocks accounted for about 20 percent of the daily trade volume on the Paris Bourse. London is in a good position because it is the home of the Euromarket and many large institutional investors as well as of the SEAQ system and the related, but different, International SEAQ. As European markets become more integrated, brokers and dealers from throughout Europe are likely to become part of the SEAQ system.

U.S. firms can benefit as American investor interest in non-American securities grows. U.S. investor portfolios now contain only about 5% foreign securities, compared to 15-20% for Europeans. As American portfolios diversify to include more offshore stocks and bonds, they will turn to U.S. firms for the most part; it is important that U.S. firms be ready and able to serve their needs through international research, distribution, and market making. U.S.

firms also have demonstrated their value to foreign issuers, particularly large equity issuers, such as governments privatizing big state companies, by demonstrating skill and effectiveness in successful engineering and executing large stock placements in the U.S. and other international markets.

MARKET MECHANISMS

There are several issues relating to the question of whether clearance, settlement, and other facets of the market are functioning soundly. The Committee is aware of the range of Cooke Committee proposals for strengthening the supervision and capital adequacy of the banking system, and the Group of Thirty proposals relating to the securities industry.

International cooperation among authorities in the area of banking has gone much further than that in the area of securities. But the dangers to the securities industry and ultimately to the international financial system itself from problems in clearance and settlement are enormous, and warrant greater attention to the development of international standards and cooperation. The Brady Commission singled out the dangers of a large default in clearance and settlements during the Crash of October, 1987. The greater the international flow of investment, and the more intense the cross border trade in international securities, the greater will be the strains on the clearance and settlement system. Problems can arise from delays, technical breakdowns, disparate national clearance and settlement systems, bankruptcy of a key player, etc. There is also an underlying prospect of a push to issue, or establish financial firm operations, in the least regulated market, adding further risk to the system. This issue of regulatory "arbitrage" has been a -particular dilemma for the U.K., which feels that its relatively tough Securities Act could place it at a disadvantage vis-a-vis continental markets after 1992 and drive firms to a more permissive environment on the continent. It is an issue for the U.S. as well.

The efforts now being made by the European Community to establish its securities regulations for 1992 should give a boost to intensified multilateral cooperation on these issues. If the EC can aim at some measure of harmonization among the practices and regulations of its members to avoid an internal set of disparities, which could lead many market activities to go to the least regulated member, that might provide some prototype ideas for a broader agreement among the U.S., Japan, Canada, Australia, Singapore, etc.

The International Organization of Securities Commissions has several working groups which address a range of regulatory issues including accounting and auditing standards, capital adequacy, and multinational offerings. It needs to tackle with far greater urgency the question of settlements and clearance. But this is also a matter for central banks, who have ultimate responsibility for national financial systems, and thus cannot help but share concerns over issues related to clearance and settlement, with their attendant risks for national financial solvency and tranquility.

On the question of crisis management, there are frequent contacts and consultations on a bilateral basis between the President of the NYSE and his counterparts in London, Paris, Tokyo and Toronto; one area in which important agreement has been reached is to give advanced warning if a decision has been made to stop trading in a given stock traded on the other's exchange.

In response to your question as to what the Congress might do, I would suggest the following. Recognizing the importance of private firms in finding answers to the clearance and settlement problem, and its considerable expertise in this complicated area, it would be useful to establish a public-private technical level committee in this country to consider the issue and to suggest that other members of the Group of Seven do likewise, with the ultimate goal of a multilateral examination and elimination of the problem.

Similarly, I would suggest, on the broader question of securities regulation and standards, that the U.S., Japan, the EC, Canada, Australia, Singapore, and Taiwan form an intergovernmental group to establish, where possible, certain minimum requirements regarding accounting, auditing, disclosure, conduct of dealers, registration criteria, etc. Where minimum standards can be agreed, there could then be mutual recognition of other nations registration requirements for new listings, and other types of cross border business in the securities industry, much as the Europeans plan to do within the Community. Finally, it would be well to bear in mind that our market does not operate in a vacuum; we need to reexamine our rather difficult listing requirements, to ensure that we are not at a disadvantage in attracting foreign stock listings, not only for the sale of our financial services industry, but also because it is not in our interest that a growing percentage of securities business take place outside U.S. regulatory supervision.

MULTI-SERVICE, MULTI-NATIONAL FINANCIAL SERVICE FIRMS.

One of the complicating factors here was brought out by the Brady Commission report -- that in the U.S., different aspects of the financial market are supervised by different agencies. The Commission suggested that unifying authority under the Federal Reserve would be a good solution; this was considered appropriate because the Fed has ultimate authority for the U.S. financial system. The Commission further argued that because the problems surrounding the crash were international in scope, and that central banks had major supervisory authority over financial markets in other nations, the Fed was the logical counterpart in the U.S.

Another problem is that the SEC does not have regulatory authority over unregistered foreign subsidiaries of U.S. securities houses, and offshore activities of foreign subs of all countries are regulated only with difficulty. A related issue is that the concept of lender of last resort has been established in the banking sector to preserve the system; what happens if the financial system is threatened by a massive liquidity squeeze on, or default by, a securities firm or group of firms? For banks, the assurance of government guarantees for depositors reduces the chance of their facing a big liquidity squeeze; for securities houses, there is no such safety net to attract liquidity in difficult times in the market.

CORPORATE ACQUISITIONS AND TAKEOVERS

This is one of the most controversial areas of international finance. It is so, I believe, in part because of its economic and business significance, and in part because foreign purchases of U.S. companies are a reminder to Americans that we are less insulated from the world than in times past, and that other nations have attained significant financial and corporate power relative to ourselves. In short, we are no longer the dominant factor in all aspects of international business or finance. It is, however, worth reminding ourselves that we as a nation save roughly $120-140 billion less than we invest; the gap must be filled from abroad. It is filled by foreign net purchases of U.S. assets, including U.S. Treasuries, corporate stocks and bonds, companies, and real estate. If we are unhappy with this net flow of foreign funds into our markets -- and the influence implied by it -- and do not wish to cut back on investment, we must increase our savings.

Putting the matter in perspective, in 1988, purely U.S. mergers and acquisitions activity amounted to 1,120 transactions with a value of $160 billion; foreign purchases of U.S. companies reached a total of just under $60 billion, accounted for by 221 transactions. The latter two figures compare to $47 billion of foreign acquisitions and 194 transactions in 1987; $31 billion and 176 in 1986; and $7 billion and 83 in 1985.

Looking broadly at global activity in mergers and acquisitions, transactions done exclusively among American buyers and sellers appear to have levelled out, while foreign purchases in the U.S., and cross border activities abroad not involving Americans as buyers or sellers, have grown dramatically. Transactions involving sales from the U.S. to foreign buyers grew from 52 in 1982, worth nearly $3 billion, to the level of 221 transactions worth $64 billion noted above; while transactions taking place entirely outside of the U.S. rose from 71, worth $15.5 billion, in 1982 to 578 worth $55.5 billion in 1988! In 1988 the $160 billion of U.S. domestic transactions was 3 times higher than in 1982, but 20% below 1985 ($200 billion).

Western European companies are the key factor in cross border M&A today. They were the biggest foreign buyers of U.S. companies, demonstrating that their interests were broader than just the internal EC market. Of the wholly non-US.. transactions noted above, 58% have been intra-European, with a large portion involving U.K. companies; also Japanese investment in the European Community is growing rapidly, albeit from a low base. And the EFTA countries, who have six times more trade with the EC than do Japan the the U.S. combined, and thus have a big stake in Europe 1992, are also major investors in the Community.

In so far as a review procedure is concerned, the issue is complicated. The British Takeover Panel has been called upon to resolve disputes which in this country we traditionally resolve through litigation. A review process for takeovers and mergers here raises important questions. Much of what concerns people about mergers and acquisitions -- other than the emotional content of the subject -- involves anti-trust or national security issues. If we are worried about a specific transaction adversely affecting competition, whether that involves a foreign or a domestic acquisition, the anti-trust enforcement route is the course to take. But it should be, and I believe is, recognized that in a world in which competition comes from abroad to an increasing degree, a merger that might have harmed competition years ago might not do so today. If there are national security concerns, there is a procedure for considering them as well.

However, as the EC develops its procedures for reviewing M&A activities, Canada maintains a review process (albeit far less restrictive than FIRA a few years ago), and it remains difficult for foreigners to buy companies in Japan, and other countries, domestic pressures here will grow for the U.S. to put in place some process of its own; it will be difficult to maintain openness here in light of perceived restrictions abroad. Before the issue gets out of control, some discussion between the U.S. and its major partners will be needed to minimize distortions and divergence among investment practices. A similar exercise will be required to minimize local content requirements, which also distort investment.

COMPETITIVENESS

The U.S. financial services industry is a critical part of the U.S. economy -- manufacturing, trade, technology, etc. The ability of a major financial firm to succeed today is crucially related to its effectiveness in operating in world financial markets.

We had feared that the notion of a "mirror-image" reciprocity test might be accepted finally by the European Community, but the Commission's new proposals reassure us on that issue. However, these proposals have yet to be considered finally by the European Parliament and by the European Council. So the issue is not settled yet. Conversations with Europeans at all levels are needed to see this through. It is also important that we urge that capital requirements be established for securities firms in such a way as not to disadvantage those firms vis-a-vis banks.

With regard to Japan, a significant number of steps have been taken to open markets to foreign securities firms; and new markets in futures, money instruments, OTC options, repos and listed options have been opened. American firms have the experience and technology to compete well in these markets. Much credit should go to the Yen/Dollar talks between the U.S. Treasury and the Japanese Ministry of Finance for this progress. It is important that the MOF continue to enhance the practice of affirmatively seeking views of foreign firms and their participation in deliberations on rules and market changes; having the Big Four dominate the process raises concerns in the minds of foreign firms, and could obscure the progress made in market opening. Both JSDA and TSE also need to open their consultative procedures to foreign firms participation. Also troublesome is the prohibition against foreign securities firms being FOREX dealers, which is permitted for securities firms (including Japanese) in the U.S. In the very important Tokyo market, we cannot directly provide foreign exchange hedging services. In all of these areas, the U.S. and MOF need to continue to work together to open Japan's markets still further; and the SEC and the CFTC need to conduct a serious on-going dialogue with Japanese supervisory authorities to build relations and strengthen their consultation and coordination efforts.

International activities of U.S. investment banks would also benefit by modifying rules on Passive Foreign Investment Companies which treat certain of their active foreign subsidiaries as passive, tax-deferred vehicles. Representative Matsui has proposed a helpful bill exempting from PFIC rules controlled foreign corporations covered by Subpart F.

It is important that the consequences of a loss of strength of the U.S. securities industry be understood. Whether individual firms thrive or falter is primarily up to them, and will be determined in part by whether they can adapt to a changing and more competitive world? That will differ from firm to firm. We are confident about our future -- but we do not take anything for granted.

With respect to the industry as a whole, competition is a critical factor pushing down fees and pressing firms to be increasingly innovative. The danger is that it is also pushing firms farther out on the risk curve. But the system is also riskier because new types of securities, new hedging devices, higher volumes, rapid movement of funds and heavy dependence on new technologies all could pose troubles for the market as well as for individual firms.

Many facets of the economy depend on a healthy financial services industry. Business needs to rely on firms not only for transactions, but also for advice, research and good ideas in tough times, and when no transactions are involved. Also foreign firms tend to be more closely linked than ours to their national industries and governments. American companies, and indeed many foreign companies want independent advice; and they need to be able to rely on firms which know world markets, know the U.S. domestic market, and are there in good times and bad.

We believe that we can compete worldwide and serve our American and non-American clients well if the playing field is level, and markets are open, along with the process of developing new rules and regulations. The U.S. financial industry helps American companies to thrive in the changing and complex global financial environment. If it faltered, or were denied the ability to compete in foreign markets, this industry and all who depend on it would suffer.

Senator DODD. Thank you, Bob.

Mr. MacDonald, we welcome you.

STATEMENT OF ALAN S. MacDONALD, GROUP EXECUTIVE, NORTH AMERICAN INVESTMENT BANK, CITICORP

Mr. MACDONALD. Thank you very much.

As a newcomer to your hearings, one thing that I find remarkable with respect to the testimony and the submissions to this subcommittee is the unanimity of views among the regulators and the different types of market participants represented by the witnesses with regard to: (1) What is actually taking place in the transformation of these global markets; (2) Where the U.S., our markets and our market participants stand in this transformation; and (3) The general consensus that seems to exist with respect to what the key issues and solutions are and what we should be doing to implement them.

So I thank you for the opportunity to join you today and to participate in this crucial process.

These hearings, as everyone has noted, have come at a crucial time. The globalization of securities markets is proceeding rapidly and the questions listed by the subcommittee in its letter of invitation are the same ones being discussed in other legislative bodies and among regulators around the world.

How the European Community, Japan, Switzerland, Canada and other countries resolve the issues you have raised will determine, along with the United States' own response, the shape of financial markets and the ability of financial firms to promote investment and growth for years to come.

What the United States itself does, vis-a-vis these issues, will largely determine the ability of financial firms headquartered in the United States to compete effectively in world financial markets and the share of global financial activity that will take place in the United States.

To set the framework for our discussion, let me if I may draw an analogy. Imagine two tanks of water separated by a wall. The water is two feet deep in one; six inches deep in the other. Punch a hole in the wall, and water flows from the first tank into the second. If the hole is low enough, the water level in the two tanks will eventually become equal.

Globalization in financial markets resembles this elementary exercise in hydrodynamics. Traditionally, technological, institutional and regulatory walls have separated financial markets in one country from those in others. These walls are coming down. National financial markets are blending into a single global financial market. This benefits seekers and suppliers of capital. Issuers can raise funds at lower cost, and investors can get higher returns without an increase in risk.

The implications for U.S. financial markets, U.S. firms, and U.S. policy are, in my view, profound. To play a leading role in the global financial market, U.S. firms will have to be able to compete on a global basis. Today they cannot. To assure that the global financial market conducts a large share of its activity in the U.S.—and so employs U.S. persons and boosts U.S. exports of services—

U.S. markets must be relatively more attractive than markets in other countries. Today they are not. U.S. firms are losing ground relative to rivals from other countries, and financial activity is flowing into other markets.

The data tell the story very clearly. Between 1981 and 1988, the Eurobond market grew from $31 billion to $216 billion, or by 691 percent; and the dollar-denominated portion of that market grew from $26 billion to $75 billion or by 288 percent. Over the same time period, the public market for foreign bonds in the U.S. increased relatively little, from $7 billion to $15 billion, whereas over the same time period, foreign bonds sold in the U.S. by private placement increased from $2 billion to $22 billion, or by 1,115 percent.

These hearings give me hope that the U.S. will respond to this global challenge to our firms and our markets. In answering the questions posed by the subcommittee, I would like, if I may, to group them under three headings. First, how will globalization change financial markets? Second, will U.S. firms be able to compete in the global market? And third, will U.S. markets remain important in the global market?

With regard to the first, how will globalization change financial markets, globalization, as we've heard, is an established fact of daily financial life. National markets are increasingly integrated with one another. Capital flows from one country to another. More importantly, investors around the world are placing an increasing share of their portfolios into securities that are issued by foreign entities or issued in foreign markets. Issuers consequently look to the global market when seeking to raise funds.

Securities, as a result, are priced in the global market. With global portfolios, so go global markets and financial instruments. Although we can see a clear trend toward global markets in all financial instruments characterized by 24-hour trading, the current situation varies greatly from one financial instrument to the next. Truly global 24-hour markets are at this time limited to foreign exchange and U.S. Treasury securities, both of which are generic, homogeneous instruments in which there are huge volumes of trading, no disclosure and reporting requirements, and uniform standards for credit clearing and settlement.

For other instruments, such as corporate stocks and bonds, the pattern and place of trading is not set as yet. As the costs of information and communication decline, factors such as taxes, reporting disclosure requirements, and efficient clearance and settlement practices become relatively more important in determining where an issue is traded and where the jobs associated with such trading are created. A global competition among markets is emerging.

This brings me to my second heading, will U.S. firms be able to compete in the global market? If U.S. firms are to compete in the global market, they will need a world class license. Today, U.S. firms do not have one and the share of U.S. firms in world markets is slipping.

A world class license is essentially a universal bank license. This is the norm in Europe and Canada, and as we heard from Chairman Greenspan, probably about to become the norm in Japan. Armed with a universal bank license, foreign firms can and do provide customers with a full range of financial services. Handicapped with a partial banking license, U.S. firms can only provide their customers with half a loaf. Consequently, U.S. customers are poorly served, particularly small and medium-sized customers, and U.S. firms are at a competitive disadvantage in world markets.

National treatment attempts to solve this problem. Under the national treatment principle, firms owned by foreign organizations are to be treated exactly the same as firms owned by domestic organizations. That allows each firm to compete in the other's markets.

In practice, this principle does not work well for U.S. banking organizations, many of whom have the potential to become world class players. They don't get national treatment. Foreign jurisdictions may grant it, as the European Commission proposed to do, but U.S. regulation won't permit U.S. banking organizations to take advantage of it.

In particular, U.S. law restricts the activity of foreign securities in insurance affiliates of U.S. banking organizations. Again, with respect to banks, there are lots of problems that are not susceptible to national treatment. For example, holding company regulations, such as capital requirements, limitations on permissible affiliations and firewalls, place a burden on the global operations of U.S. bank holding companies that foreign competitors simply don't have to bear. These burdens have become heavier under the risk-based capital accord that harmonized capital requirements by raising them for U.S. bank holding companies, but it did nothing to put U.S. banking organizations on an even footing with their foreign competitors.

Only one thing will do that. Give U.S. banking organizations a full banking license, not a partial one, allow banks to become affiliated with any other financial or non-financial enterprise, subject only to limited restrictions on their transactions with affiliates. This would allow U.S. firms to compete throughout the world. According to the FDIC, for banks, this would clearly enhance safety and soundness and thus protect the deposit insurance fund.

With a world class license, U.S. banking organizations can be world class players. Without it, they will increasingly be condemned to the minor leagues.

This brings me to my third and final heading, will U.S. markets remain important in the global market? Just as financial service firms need to be world class, so do U.S. financial markets if they are to retain their share of global financial activity. Already that share is slipping. Not so long ago, the bulk of the world's outstanding securities and the bulk of the world's securities trading occurred in the U.S. markets. That is no longer the case.

The U.S. accounts for less than half of the world bond market and for less than a third of the world equity market. Part of this relative decline, as we've discussed, is clearly due to the growth of other economies, particularly Japan. But much of it is due to the failure of the U.S. to keep its securities markets attuned to the needs of issuers and investors, particularly institutional investors.

As a result, foreign issuers rarely raise funds in the United States and domestic issuers regularly raise funds outside the United States. Indeed, there have been times recently when U.S.

corporations have raised more funds in markets outside the United States than they have in the United States.

Need this be the case? Can U.S. markets regain their lost preeminence, or is the U.S. condemned to see financial activity flow out of the country the way so much manufacturing activity has done? Plainly, if the U.S. is to restore its claim to be the world's financial center, it must make its markets as competitive as those in London, Tokyo, Paris, Frankfurt, Amsterdam and the other cities around the world that are, or are vying to become, financial centers.

Such a restoration program has two parts. The first is to let all financial firms compete in the U.S. market, including United States and foreign banking organizations that are currently barred by the Glass-Steagall Act from underwriting securities in the United States. If the United States is to be a world class market, it has to make world class players welcome.

The second part of such a restoration program is to make the market itself more efficient. That involves doing away with superfluous reporting and disclosure requirements, particularly for those markets where the parties on all sides are professionals, improving clearance and settlement practices, and confining the enforcement of U.S. law to the United States.

With respect to SEC regulation generally, it is worth adding emphasis to the point that the markets are clearly institutional in nature. That is, where all parties are securities professionals or sophisticated institutional investors. In these markets, many SEC disclosure and reporting regulations are superfluous. Market professionals have access to material information from many sources other than SEC documents. Information that is provided by regulation is often not that which is most helpful to this class of investor, but rather is designed to meet the needs of the less seasoned individual investor.

On the institutional side of the business, therefore, we would encourage the SEC to consider more creative approaches to regulation such as adoption of proposed Rule 144(a) which would facilitate a secondary market in certain unregistered securities that are traded among large sophisticated investors.

We would also support SEC and private sector initiatives to improve international security law enforcement and achieve global market reform.

A mutual recognition approach to inconsistent home regulations would enable issuers and investors to rely on the fact that all market participants are in compliance with at least their home country's laws and regulations, thus assuring them of some discernible minimum standard while simultaneously enabling them to engage in various cross-border activities without impediment.

Currently, foreign issuers seeking to enter the U.S. markets must prepare additional disclosures, a costly exercise that effectively bars all but the largest foreign companies from entering the U.S. equity markets.

Conversely, there are trade barriers to U.S. companies entering the foreign equity markets due to differences in financial reporting practices. The net result of these differences is to raise costs for U.S. issuers and keep financial activity out of the United States.

In an apparent attempt to rectify certain of these issues, we understand that the SEC will be considering a proposal this summer that adheres to the principles of mutual recognition and regulatory coordination with Canada regarding the 1933 Act registration and certain 1934 Act reporting requirements.

In sum, Mr. Chairman, globalization poses a challenge to U.S. firms and U.S. markets and therefore to U.S. policy. If the United States is to play a leading role in this new environment, it must do two things: let U.S. firms compete, and make U.S. markets more competitive. Thank you very much.

[The complete prepared statement of Alan S. MacDonald follows:]

The Globalization of Financial Markets: Implications for U.S. Firms, U.S. Markets and U.S. Policy

Statement of

Alan S. MacDonald
Group Executive
North American Investment Bank
Citicorp

before the

Subcommittee on Securities
of the
Committee on Banking, Housing and Urban Affairs
United States Senate

June 14, 1989

Good morning. My name is Alan MacDonald. I am Group Executive for the North American Investment Bank at Citicorp. I am pleased to testify before you here today on this important issue.

In your letter of invitation you referred to "multiservice, multinational financial services firms". Citicorp certainly fits that description. It provides deposits, credit, securities, insurance and information services to over twenty-five million households and to hundreds of thousands of corporations, financial institutions and governments from over 3,000 offices located in over ninety different countries. We are market leaders in consumer credit, corporate finance, foreign exchange and derivative products, securities clearance and settlement, custody and payments processing. We have extensive experience in all aspects of securities underwriting, trading and distribution, including the offering of securities on a global scale. We also conduct extensive activities in insurance and information services. We are active in each of the world's major financial markets, and have been so for a long time -- in New York since 1812, in London since 1902 and in Japan since 1902, as well (with interruption during World War II).

These hearings come at a critical time. The globalization of the securities markets is proceeding rapidly, and the questions listed by the Subcommittee in its letter of invitation are the same ones being discussed in other legislative bodies and among regulators around the world. How the European Community, Japan, Switzerland, Canada and other countries resolve the issues you have raised will determine, along with the United States' own response, the shape of the financial markets and the ability of financial firms to promote investment and growth for years to come. What the U.S. itself does vis-a-vis these issues will largely determine the ability of financial firms headquartered in the United States to compete effectively in world financial markets and the share of global financial activity that will take place in the United States.

To set a framework for our discussion, let me draw an analogy. Imagine two tanks of water separated by a wall. The water is two feet deep in one; six inches deep in the other. Punch a hole in the wall, and water flows from the first tank into the second. The larger the hole, the faster the water will flow. If the hole is low enough, the level of water in the two tanks will eventually become equal.

Globalization in financial markets resembles this elementary exercise in hydrodynamics. Traditionally, technological, institutional and regulatory walls have separated financial markets in one country from those in others. These walls are coming down. National financial markets are blending into a single global financial market. This benefits seekers and suppliers of capital. Issuers can raise funds at lower cost, and investors can get higher returns without an increase in risk.

The implications for U.S. markets, U.S. firms, and U.S. policy are profound. To play a leading role in the global financial market, U.S. firms will have to be able to compete on a global basis. Today they cannot. To assure that the global financial market conducts a large share of its activity in the U.S. -- and so employs U.S. persons and boosts U.S. exports of services, U.S. markets must be relatively more attractive than markets in other countries. Today they are not. U.S. firms are losing ground relative to rivals from other countries, and financial activity is flowing into other markets.

Between 1981 and 1988, the Eurobond market grew from $31.3B to $216.3B or 691%, and the dollar denominated portion of that market grew from $25.8B to $74.5B, or 288%. Over the same period, the public market for foreign bonds in the U.S. increased relatively little, from $6.9B to $14.6B. Over the same period, 1981 to 1988, foreign bonds sold in the U.S. by private placement increased from $2.0B to $22.3B or 1115%.

These hearings give me hope that the U.S. will respond to this global challenge to our firms and our markets. In answering the questions posed by the Subcommittee I would like, if I may, to group them under three headings: How will globalization change financial markets? Will U.S. firms be able to compete in the global market? Will U.S. markets remain important in the global market?

HOW WILL GLOBALIZATION CHANGE FINANCIAL MARKETS?

Globalization is now a fact of financial life. National markets are increasingly integrated with one another. Capital flows from one country to another. More importantly, investors around the world are placing an increasing share of their portfolios into securities that are issued by foreign entities or issued in foreign markets. Issuers consequently look beyond their local market when seeking to raise funds. Securities are therefore priced in a global market.

Three fundamental and irreversible forces are driving the trend toward globalization in financial markets. The first of these is technology. Since 1964, the real cost of recording, transmitting and processing information (including financial information) has fallen more than 95 percent! What cost a dollar in 1964 now costs five cents. This tremendous cost reduction makes it cheeper to assess the risk and rewards of financial assets, cheaper to record and process trades, cheaper to manage portfolios and cheaper to match the users with the suppliers of capital. Twenty-five years ago financial information was locked away in file cabinets at banks, brokers and other traditional financial intermediaries; today it is available to virtually anyone at a push of a button.

The second major force at work is the institutionalization, or changing pattern, of household savings. Throughout the world, the individual investor is giving way to the institutional investor. This should not be surprising. Few individual investors have the resources, ability or time to manage their own portfolios as well as institutions can do it for them. Institutional forms of saving, such as pension funds, often have tax advantages not available to individuals. Institutions also offer better diversification than individuals can hope to achieve on their own. Relative to each dollar invested, institutions can manage portfolios at lower cost than can individuals. Finally, fiduciary obligations and competitive pressures induce institutions to provide professional, prudent management and best execution for their customers. Consequently, individuals tend to concentrate their efforts on earning and saving; they let institutions do the investing.

The third major force behind globalization is financial innovation. All of this professionally managed capital would mean very little, if there weren't a wide range of choices for investment. Advances in the theory of finance, combined with all of the technology that I mentioned earlier, have made it possible to develop a wide range of new derivative financial instruments, such as options, swaps and futures, and to trade these new derivatives. By using derivatives it is possible to segregate exchange rate risk, credit risk, interest rate risk, and the liquidity risk that used to be bundled together, for better or for worse, in the traditional loan or security. In particular, by using currency swaps, it is possible for an investor to lay off the foreign exchange risk in a foreign bond or stock. This ability to segregate risk makes it possible for financial institutions to build instruments that exactly suit the preferences of suppliers and seekers of capital. In other words, financial institutions will transform what issuers want to sell into what investors want to buy.

Thanks to the reduction in the cost of processing and transmitting information, this matching of issuers and investors is increasingly occurring on a global scale. As a result, components of a financing for an issuer in Germany may fit into portfolios of investors in the UK, Spain, Australia, and Japan. Conversely, an asset held by a Dutch investor may be comprised of claims on issuers in France, Italy, Singapore, and the U.S. The net effect is a more efficient capital market. Seekers of capital can obtain it at lower costs and suppliers of capital can get greater liquidity and higher returns.

As the costs of global diversification have declined, so have the barriers to much diversification. During the postwar era there has been a progressive decline in the number of countries imposing exchange controls, the range of transactions that such controls cover and the severity of the controls that remain in place. Further reductions are in the offing. To name but two examples: The European Community plans to remove all barriers to the movement of capital among its Member States by 1992 as part of its single internal market program. Japan is in the process of raising the amount of foreign securities that its financial institutions are permitted to hold.

Together these factors have led to the globalization of investors' portfolios. Institutional investors are increasing the share of foreign bonds and stocks in their portfolios.

With global portfolios go global markets in financial instruments. Although we see a clear trend toward global markets in all financial instruments, characterized by 24 hour trading among institutions, the current situation varies greatly from one financial instrument to the next. Truly global, 24 hour markets are at this time limited to foreign exchange and U.S. Treasury securities: generic, homogeneous instruments in which there are huge volumes of trading, no disclosure and reporting requirements, and uniform standards for clearance and settlement. For other instruments, the pattern and place of trading is not set as yet, but ease of communication should assure that trading gravitates toward the environment that offers investors the ability to transact at the lowest costs.

The foreign exchange market is a global, 24 hour market. The instrument is generic: dollars for yen; yen for DM, etc. The volume of trading is huge: some $400 billion per day, according to recent estimates. The market itself has no physical location or exchange. It is in effect a network of computer terminals on traders' desks in financial institutions around the world that are linked together electronically. Each trader seeks the same set of exchange rates at the same point in real time. The location of participants is secondary. Institutional trading dominates. There are no disclosures or reporting requirements. Governments can say what they like about monetary policy. Clearance and settlement are relative simple. Under a foreign exchange contract, the two parties agree to exchange certain amounts of cash. There is no security to exchange; each party simply pays the other the amount of currency that it owes the other through the normal payments process. Competition is fierce; spreads are extremely small, so that from the customer's viewpoint the instrument is highly liquid. He can sell a large volume of foreign exchange quickly without moving the price.

The other global, 24 hour market is the market for U.S. Treasury securities. This too is a highly generic instrument; all Treasury securities have the same credit risk. They differ principally in coupon rate and maturity. At $110 billion per day, the volume of trading is huge by any standard except that of the foreign exchange market. This market also never closes. Trading occurs around the clock among major financial institutions on behalf of their clients and for their own account. Once again, there are no disclosure or reporting requirements. Clearance and settlement is uniform. All Treasury securities are held in book entry form on the books of the Federal Reserve Bank of New York, and all trades are cleared and settled through that system. Again, competition is fierce, and spreads are small. Treasury securities are highly liquid.

Once we go beyond these two instruments, trading patterns are not as firmly set. Instruments such as corporate bonds and stocks are not as homogeneous as foreign exchange and U.S. Treasury securities. For example, IBM stock differs quite markedly from that of Siemens or Toyota. The total value of daily trading in even the most active stocks is on the order of $100 million per day, or considerably less than 1% of the trading in U.S. government securities or foreign exchange. Disclosure and reporting requirements are important, and standards differ from one country to another. Clearance and settlement practices also differ markedly.

International securities trading in stocks and bonds therefore tend to be concentrated in a single market. Traditionally, this has been the market in which the issuer is incorporated, but this is now changing. Trading is now migrating to the environment which offers investors the best price and highest liquidity for their securities. As the costs of information and communication decline, factors such as taxes, reporting and disclosure requirements, and efficient clearance and settlement practices become relatively more important in determining where an issue is traded -- and where the jobs associated with such trading are created. A global competition among markets is emerging.

In sum, globalization is an irreversible trend. Investors increasingly manage global portfolios, and securities prices are increasingly determined in global markets. Thus, to be a leading financial institution, a firm must be able to compete in global markets. To be an active trading area, a market must make itself attractive relative to others. How the U.S. regulates its financial firms and financial markets will go a long way toward determining how they fare in the global marketplace.

WILL U.S. FIRMS BE ABLE TO COMPETE IN THE GLOBAL MARKET?

If U.S. firms are to compete in the global market they will need a world class license. Today, U.S. firms don't have one, and the share of U.S. firms in world markets is slipping.

A world class license is essentially a universal bank license. This is the norm in Europe and Canada, and Japan is moving in this direction as well. Armed with a universal bank license, foreign firms can and do provide customers with a full range of financial services. Handicapped with a partial banking license, U.S. firms can only provide their customers with half a loaf. Consequently, U.S. customers are poorly served, particularly small- and medium-sized companies, and U.S. firms are at a competitive disadvantage in world markets.

Under a universal bank license, banks may conduct a full range of securities activities whether directly in the bank itself or via wholly owned subsidiaries. Affiliations with other types of financial companies are also permitted. In particular, most countries outside the U.S. permit insurance companies to own banks or banks to own insurance companies. Some countries also permit industrial companies to own banks or banks to own significant equity stakes in non-financial companies.

Regulation of these multiservice firms is on a functional basis, i.e., the banking regulator regulates the bank, the insurance regulator, the insurance company, etc. To the extent that a parent holding company exists, it tends to be regulated as a normal business enterprise subject to the securities and antitrust laws, much as American Express is regulated in the United States. In particular, there tends to be no holding company capital requirements. Nor is there much in the way of firewalls between banks and their non-bank affiliates, aside from a requirement that the aggregate of the bank's loans to its different affiliates be less than the bank's legal lending limit -- a limit, I might add, that tends to be higher than that permitted to U.S. banks.

As to the safety net applicable to multiservice firms, the practice outside the United States is to have a limited amount of deposit insurance (or none at all) and to have the central bank act as the lender of last resort. In most jurisdictions this means that major securities firms have access to the lender of last resort, either because they are themselves a bank, are owned by a bank that is permitted to downstream funds into it, or, in the case of the major Japanese investment houses, because government policy grants them direct access to the discount window.

In contrast, the United States still separates commercial and investment banking, and it restricts the ability of insurance companies and non-financial firms to be affiliated with banks. It imposes a system of bank holding company supervision uniquely onerous in terms of capital requirements, restrictions on transactions among affiliates, and requirements to seek prior approval before entering new lines of business.

The rationale for this unique U.S. approach to regulation is said to be the uniquely protective U.S. safety net. Yet deposit insurance in the U.S. is limited by law to a certain amount per account, just as it is in other countries. And, the lender of last resort is in some ways less protective in the U.S. than in other countries, since it is restricted to banks only, rather than being available directly to other firms (as for example to the large Japanese securities houses) or indirectly to non-bank affiliates of banks with access to the discount window. Thus, if there is a rationale for the unique U.S. system of regulation it presumably lies elsewhere.

It is difficult to believe that safety and soundness is the reason. It is instructive to note that only one U.S. bank holding company is rated AAA (and then only by Moody's), while there are at least seven European universal banks with that rating by both Moody's and S&P (Union Bank of Switzerland, Credit Suisse, Swiss Bank Corporation, Deutsche Bank, Barclays, National Westminster, and Rabobank). Four of those seven have grandfathered securities affiliates in the United States that are free to underwrite and distribute securities throughout the United States. Thus, it is not readily apparent that the U.S. system is either safer or sounder.

The difference between the U.S. system of partial banking and the universal bank system that is increasingly the standard in the rest of the world make it difficult to regulate multinational financial firms. To assure competitive equality, U.S. firms need to be on a par with universal banks in foreign markets. Universal banks need to be on a par with U.S. firms and U.S. markets.

The policy of national treatment attempts to solve this problem. This principle states that firms owned by foreign organizations should be treated within each country the same as firms owned by domestic organizations. Thus, the national treatment principle allows each nation to follow its own regulatory regime, and firms to compete with each other on equal terms in each others' markets.

The trouble is that U.S. banking organizations don't get national treatment. Foreign jurisdictions may grant it, as the European Commission has proposed to do, but U.S. regulation won't permit U.S. banking organizations to take it. In particular, U.S. law restricts the activity of foreign securities and insurance affiliates of U.S. banking organizations.

There are also problems that are not susceptible to national treatment. For example, holding company regulation (capital requirements, limitations on permissible affiliations, firewalls) places a burden on the global operations of U.S. bank holding companies that foreign competitors simply don't have to bear. These burdens have become heavier under the risk-based capital accord that harmonized capital requirements (raising them for U.S. bank holding companies), but it did nothing to put U.S. banking organizations on an even footing with their foreign competitors.

Only one thing will do that. Give U.S. banking organizations a full banking license, not a partial one. Allow banks to become affiliated with any other financial or non-financial enterprise, subject only to limited restrictions on their transactions with affiliates. This would allow U.S. firms to compete throughout the world. According to the FDIC, for banks, this would also enhance safety and soundness and thus protect the deposit insurance fund.

With a world class license, U.S. banking organizations can be world class players. Without it, they will increasingly be condemned to the minor leagues.

WILL U.S. MARKETS REMAIN IMPORTANT IN THE GLOBAL MARKET?

Just as U.S. banking organizations need to be world class, so do U.S. financial markets, if they are to retain their share of global financial activity. Already that share is slipping. No so long ago, the bulk of the world's outstanding securities and the bulk of the world's securities trading occurred in U.S. markets. That is no longer the case. The U.S. accounts for less than half of the world bond market and for less than a third of the world equity market.

Part of this relative decline is due to the growth of other economies, particularly Japan. But much of it is due to the failure of the U.S. to keep its securities markets attuned to the needs of issuers and investors, particularly institutional investors. As a result, foreign issuers rarely raise funds in the U.S., and domestic issuers regularly raise funds outside the U.S. Indeed, there have been times recently when U.S. corporations have raised more funds in markets outside the U.S. than they have in the U.S.

Need this be the case? Can U.S. markets regain their lost preeminence, or is the U.S. condemned to see financial activity flow out of the country the way so much manufacturing activity has done? Plainly, if the U.S. is to restore its claim to be the world's financial center, it must make its markets as competitive as those in London, Tokyo, Paris, Frankfurt, Amsterdam and all the other cities around the world that are, or are vying to become, financial centers.

Such a restoration program has two parts. The first is to let all financial firms compete in the U.S. market, including U.S. and foreign banking organizations that are currently barred by the Glass-Steagall Act from underwriting securities in the U.S. If the U.S. is to be a world class market, it has to make world class players welcome.

The second part of such a restoration program is to make the market itself more efficient. That involves doing away with superfluous reporting and disclosure requirements, improving clearance and settlement practices, and confining the enforcement of U.S. law to the United States.

Financial Reporting and Disclosure Standards

The U.S. probably has the most extensive financial reporting and disclosure standards in the world. They are probably also the most expensive, and this has, in the opinion of Bevis Longstreth, a former Commissioner of the SEC, helped keep foreign issuers out of the U.S. and helped drive U.S. issuers into foreign markets. As I mentioned above in the section on globalization, as the cost of communication declines, the ease of migration to other markets increases for both issuers and investors. Thus, if the U.S. is to halt the exodus of issuers from its markets, it has to reduce the relative cost disadvantage currently imposed by its extensive reporting and disclosure requirements.

Three approaches are possible. The first is harmonization, so that markets the world over would have the same reporting and disclosure requirements. Currently, foreign issuers seeking to enter the U.S. markets must prepare additional disclosures. Foreign issuers from certain countries must restate their financial statements in accordance with U.S. generally accepted accounting principles. This is a costly exercise and effectively bars all but the largest foreign companies from entering the U.S. equity markets. Conversely, there are "trade barriers" to U.S. companies entering the foreign equity markets due to differences in financial reporting practices. Foreign securities regulators do not automatically accept the financial statements of U.S. companies prepared in accordance with U.S. generally accepted accounting principles as a basis for listing in local capital markets. Usually additional disclosures are required. The net result of these differences is to raise costs for U.S. issuers and to keep financial activity out of the U.S.

To reduce these differences in accounting rules, the International Accounting Standards Committee (IASC) is trying to gain greater acceptance of its standards as the basis for multinational securities filings. It appears that the International Organization of Securities Commissioners (IOSCO) has indicated that it would consider using IASC standards for multinational securities filings if the IASC upgraded its existing standards (by reducing alternative accounting methods) and took on new projects to fill in the gaps - such as cash flow reporting, earnings per share and intangibles. We support internationalization of accounting rules and believe that active and open support of the Securities and Exchange Commission would further this effort. However, this harmonization is unlikely to be achieved quickly, and other approaches should be tried in tandem with this effort at harmonization.

Mutual recognization is a second possible approach. Reports and disclosures that fulfill the requirements of one market would be accepted as fulfilling the requirements of the other. The European Commission has proposed such a system with respect to prospectuses for new issues. Prospectuses that meet the listing requirements for one exchange would be considered to have met the requirements for all exchanges within the Community.

A third approach is to eliminate reporting and disclosure requirements, at least for issues that are sold to and traded among institutions rather than individuals. This is the approach taken by the SEC in its proposed Rule 144A. This proposed rule change appropriately recognizes that the need of institutions for protection differs from that of individuals. Institutional investors have the resources to hire sophisticated managers. Such investors also by and large have a fiduciary duty to their clients to act in a professional and prudent manner, including informing themselves as to the character and capacity of the counterparties with whom they deal. The protection to the ultimate beneficiary therefore comes through statutes such as ERISA, the Investment Company Act and the National Bank Act. Hence, there is ample room to liberate trading and investment among institutional investors. Rule 144A will help arrest and may even help reverse the flow of securities market activity from the United States.

Clearance and settlement: soundness, strength, and efficiency of market mechanisms

Reporting and disclosure help the investor determine what to buy. Clearance and settlement enable him to take possession of securities he has bought and be paid for securities he has sold. Thus, clearance and settlement practices can be as important as reporting and disclosure in determining where securities market activity will take place.

Clearance and settlement also carry risks. Our assessment of the soundness, strength, and efficiency of current market mechanisms is that while they are far from ideal, they are capable of supporting the peak global trading volumes seen in recent times. While the events of October 1987 clearly put a strain on clearance and settlement systems worldwide, there were no failures that could be attributed solely to shortcomings in any one particular market support mechanism.

However, while the system is not in crisis, i.e., it "works" from a technical standpoint, the diversity of practices across markets and instruments does create barriers to further globalization of financial markets. This diversity also creates risks which may affect individual market participants as well as the underlying markets in which they trade.

We believe that the market appreciates the vital role that clearance and settlement systems play in assuring an efficient global capital market, and we believe that market participants are taking timely steps to assure that the world's securities markets will operate even more efficiently than they do today.

The factors which cause risks in clearance and settlement include:

- the absence of compatible trade comparison (also called confirmation and matching) systems for both international and domestic trades;
- different settlement periods for different markets, ranging from same day settlement to several weeks;
- the lack of delivery versus payment (DVP), leaving one or the other party unduly exposed to counterparty default; and
- the absence of book entry processing for settlement of securities transactions in many markets.

To reduce these risks, it is necessary to shorten the time between trade date and settlement date, to promote guarantees of trades made, and to assure the simultaneous exchange of payment and securities.

Several organizations from the private sector, including the Group of 30, FIBV (Federation Internationale des Bourses de Valeurs), and ISSA (International Society for Securities Administrators) have come out with specific recommendations along these lines. There is a concerted effort in place now to promote the recommendations put forth in papers such as the Group of 30 "Clearance and Settlement in the World's Securities Markets" in markets through the establishment of national implementation committees.

Although we expect that this private sector initiative will lead to implementation of these recommendations without the need for change in legislation, the various national steering committees appreciate the cooperation and support that they have received from public sector institutions. In the U.S., the SEC and Federal Reserve Bank of New York have publicly pledged their concurrence and support for the recommendations, and the steering committee shall continue to solicit their advice and support as work proceeds on this important project.

With respect to the U.S., a Steering Committee stemming from the Group of 30 effort has been established to work towards the implementation of those recommendations relevant to the U.S. securities markets: a three day settlement cycle ("T+3") (in contrast to the T+5 system now in place for stocks) and need for same day funds settlement within our DVP process. We strongly believe that these changes will improve the efficiency of the U.S. securities markets and that they may help attract additional securities business to the United States.

Extraterritoriality

The final component of the program to make U.S. markets more competitive is simple: avoid extraterritorial applications of U.S. law. Such decisions impose sovereign risk on issuers and investors who deal with U.S. institutions or foreign institutions having operations in the U.S. That is hardly the way to make U.S. institutions and U.S. markets more competitive. As the Economist pointed out with reference to a U.S. court decision allowing the SEC to attach the assets of Standard Chartered's Hong Kong branch in satisfaction of its claim against one of Standard Chartered's customers in New York:

> With financial markets now global and with capital markets able to flow freely across borders, the proper way to deal with insider trading and other legal problems is through mutual cooperation, not arbitrary smash and grab.

SUMMARY AND POLICY CONCLUSIONS

In sum, globalization is an irreversible trend. National financial markets are blending into a single global financial market. If the U.S. is to play a leading role in this new environment, it must do two things: let U.S. firms compete, and make U.S. markets more competitive.

Senator **Dodd**. Thank you very much for your testimony this morning.

We've been joined by our colleague, Senator Pressler. Senator, do you have any comments that you would like to make at the outset?

Senator **Pressler**. Thank you, Mr. Chairman. I may have some questions. I'm also making a quorum in two other committees this morning, one of which we're both a member of, but we're holding media monopoly hearings over in Commerce and markup in Foreign Relations. I do have some questions but I'd be glad to ask them after yours.

Senator **Dodd**. Well, fine.

We've covered a lot of ground. Your opening statements were all very helpful.

Mr. MacDonald, you just commented very clearly on your views regarding Glass-Steagall and, and since that was a subject of some discussion here this morning, I wonder if you two might just quickly comment on the Glass-Steagall issue and Mr. MacDonald's comments. Also, comment on the savings issue which came up earlier. I'm just trying to go back over some of the points that the chairman discussed, and then we'll come back to the regulatory coordination aspects of globilization. I'd also like to get back to you, Mr. MacDonald, for some comments on your suggestions of what you call a world class license approach and have Mr. Hormats and Mr. Heimann comment on that.

But would you comment on the Glass-Steagall and savings issue first.

Mr. **Hormats**. Just briefly, on this question with respect to the issue of why U.S. markets are losing share in new issues and in terms of trading, I would submit Glass-Steagall has very little to do with that.

Let me just elaborate briefly. First of all, the point was made about the inability to attract world class companies to the U.S. market. Several of the very large foreign universal banks—the German banks in particular and others—are grandfathered here so that they can do what they want to do. And it's not that we're not able to attract world class financial institutions to our market. All the big world class financial institutions are in this market.

The Japanese problem you discussed with Chairman Greenspan; there are a lot of reasons why some of the Japanese firms are not thriving as well in this market as might be anticipated. Few of them have to do with Glass-Steagall. They have to do in large measure with their approach to the market—with the way they trade back home. The Japanese firms are used to a very large group of investors with whom they can place their paper they underwrite, and they don't have to be particularly aggressive about selling at home to do that.

The Japanese are also having similar problems in a very open Euromarket, so it is not a Glass-Steagall issue that makes life difficult for the Japanese here, or for other securities firms, or for the securities market.

One of the reasons that a lot of this business has drifted abroad is that the big savings around the world are abroad. There is a tendency to borrow in the market where the savings tend to be largest, where the net savings tend to be greatest.

The Japanese are big buyers of American Treasury bonds because the Japanese are big savers, Treasury bonds are secure instruments. They buy a lot of them. They buy a lot of American corporates. They buy a lot of American common stock, because they are big savers and they have more savings than they invest at home.

In Germany, you have a very cramped financial system. It's dominated by the big German banks. They don't have Glass-Steagall, but they have three banks which have a very substantial presence because they are on the boards of many German companies. As you know, and they play a very dominant role in that market. They are a big savings market, however, and the Germans are big net buyers of foreign securities, because they have an excess of savings which go abroad. Some of that trading is done in the London markets and some of it is done in the Frankfurt market.

So that in general I don't know that the argument that Glass-Steagall is a big inhibiting factor is as salient a point in looking at the problems that you're looking at as the differentials in savings rates, as differences in banking practices of a non-regulatory nature in a lot of these countries.

I would say, however, I do agree on the question of making sure our market is competitive. I mentioned earlier the fact that we're not getting as many foreign listings in our markets relative to foreign listings taking place in other markets. And that strikes me as something we need to look at. Are we being too rigid from a regulatory point of view? We're going to see also that the Europeans over a period of time are going to have an even more fluid market. For the moment, the ISE gets a tremendous amount of continental business, 20 percent of the trading in French securities is done in London on the ISE. What's going to happen is that there is likely to be more done there as the Community integrates. There have been proposals for denominating certain shares in ECUS, the European Trading Units, and having them traded in different markets.

So the European market is going to be a very competitive market.

Senator DODD. Not a closed one, in your view, at all?

Mr. HORMATS. No. I'm not particularly worried about it. I think we have to be vigilant, but if the Second Banking Directive as amended by Leon Britton and the Commission holds up in its current form, we or Citibank or Merrill, who have a banking license in London, will be able to get a European passport and do virtually anything in Europe that a European financial firm can do. So that issue doesn't trouble me too much.

But we have to watch. We have also to recognize, that this has not gone through the European Parliament, and it's important to recall (a) the European Parliament is increasing in power and (b) the last time the Commission sent them the second banking directive they wanted a more stringent approach to reciprocity—that is, the Parliament did—than the Commission. The Commission has come back with what I consider to be a very reasonable approach to this. But there are politicians in the Parliament who may want to take a somewhat tougher view. So the game is not completely over. The Treasury did a good job in representing American interests there. The financial community did likewise. I know John and his colleagues in London have been very active in this, and we've got to continue to be vigilant.

Senator DODD. I was trying to recall the name of the—you said why is there so much activity in other countries and you point to the savings issue. It's sort of the Willie Sutton on banks.

Mr. HORMATS. That's right. That's where the money is. But it's true.

Also, just one last point. It is true that if you look at the currency of denomination of bonds and fixed-income securities, about 10 or 15 years ago, roughly 75 percent of the Euro-issues were denominated in dollars. The figure has gone down to about 40 percent. In part, because other currencies are playing a greater role globally, but in part because lenders often prefer to lend in their own currencies rather than the currency of the borrower. If the borrower is going to borrow, they say let him take the currency risk. So you have 15 years ago very few bonds denominated in yen, and now 10 to 12 or 15 percent of the Euromarket is. As other countries become big net exporters of capital or big international lenders, they would like more of it to be lent in their own currency and therefore the borrower takes a greater degree of the currency risk.

So it's really part of an evolution of markets, and the savings rate differential is a very important part of that. The nature of the Japanese economy is a very important part of that. But there are a lot of factors here and I wouldn't necessarily put Glass-Steagall at or near the top.

Mr. HEIMANN. Mr. Chairman, you must not have expected total agreement if you asked the Glass-Steagall question to a commercial banker and to an investment banker.

Senator DODD. We put you next to each other for that reason.

Mr. HEIMANN. I'm going to wear a combination of a hats if I may, as an ex-supervisor of the banking system and as an investment banker.

I am reminded, unfortunately, of the discussions on Regulation Q going back not too many years. There's a tendency in our system to have Pavlovian reactions to certain words. Everybody blames them for all the ills because for one reason or another those words symbolize to the speaker just how their ox is being gored,

Is it a problem for the United States of America that the securities listed on the Tokyo Stock Market are valued more than the New York Stock Exchange? Is that really a problem? Is that the result of Glass-Steagall or of the SEC, for example? Or is it a result of the strength of the savings of Japan, the growth of their industry? And conversely, the inability of this country to deal with some of these issues—fiscal and monetary policy, the budget deficit, and the level of savings?

It was not a problem when the United States was the dominant factor in the world as a result of our level of savings, our productivity, and our research and development. The values of Tokyo represent the Japanese commitment to thrift and productivity. It is not that there is something inherent within our system of banking that has made this happen.

The same thing is true for the Eurobond market. The Eurobond market has served the world very well and American issuers very well and there have been precious few problems in the Eurobond market in terms of all of the things with which this committee is concerned.

And is there something very worrisome about the fact that foreign issuers choose not to use the U.S. markets to raise money? Is that really worrisome? Is it worrisome to the U.S. economy? How? I raise these as questions because I know they're thrown out as arguments for Glass-Steagall repeal.

It's not worrisome to the financial intermediaries who happen to be American because all of us at Citibank, Goldman Sachs and Merrill Lynch and all the rest work equally as well in the Eurobond market as well in the U.S. market. So there is not the problem.

The question do we wish to modify the standards that have been adopted through the SEC over the years, and that is an issue that's a critically important one for the Congress to decide. The SEC, after all is said and done, has done exactly what the Congress asked them to do 50 years ago and done, in my opinion, brilliantly well.

So I don't think this comes down to just Glass-Steagall. A lot of factors are combined, including Glass-Steagall, interstate banking, and fiscal policy et cetera.

I realize that today's buzz word is Glass-Steagall. But interstate banking, has caused more problems for the commercial banking system in the United States than Glass-Steagall because it did not permit our commercial banks to stretch out—and create the kind of network that their competitive foreign banks have that give them capital strength and profit and loss strength, etc.

Securities firms in the United States such as Merrill Lynch can branch, if you wish to use those words, nationwide, but Citi or Bank of America or Continental Illinois, are not permitted to do that.

So the problem is much deeper, if I may say so, than just the issue of Glass-Steagall.

As far as savings are concerned, I think you spoke to that before, Mr. Chairman, and Chairman Greenspan did. I have nothing to add to those comments. At the heart of our problem is the balance of monetary and, fiscal policy, and of course, our low level of savings.

Senator **Dodd**. I'm going to give you a chance, Mr. MacDonald, to come back on this, but what you suggest to us here is we're focusing far too little attention on the developmental goals of our financial institutions and far too much on the regulatory aspects of this, and I sort of agree with that. That doesn't mean that aspects of Glass-Steagall should not be looked at. I think they should be. Why don't you comment on that since you placed such an emphasis on it, Mr. MacDonald.

Mr. **MacDonald**. Well, I think it would be wrong to overemphasize, as the other witnesses have mentioned, the importance of Glass-Steagall in the larger context of the deliberations of this Subcommittee. We at Citicorp have a particular view on Glass-Steagall, and it's probably more relevant to us than it is to a lot of other people. I think the context has been described quite clearly. The macroeconomic context to what's going on includes the United States and Japanese savings differences, as we've discussed. It also includes, however, an additional problem in relation to the international flow of funds. If you go back to the 1970s, the flows of funds were from the OPEC countries who had the surpluses to the LDC's who had the deficits. The financial intermediation process by which funds got recycled was a banking process. The OPEC countries basically placed deposits on the liability side of the balance sheet of the banking system, and the banking system recycled these "petro dollars" by making loans to the LDC's.

The global flows in the 1980s are substantially and significantly different. The deficits are no longer in the developing countries. They are here, in the United States and the surpluses are primarily in Japan and to a lesser extent but importantly in Europe. The recycling process is taking place through the securities markets. That's a reality. If you really want to know why Japan is going gangbusters in terms of the statistics. We have all recited a large part of it has to be attributed to the fact that the securities markets are following the capital surpluses.

So the question really is, what do we think about the fact that the 1980's process is a securities process and that, in addition, we have global institutional investors taking a larger and larger share of responsibility for the investment of individual's funds. Both the global flow of funds and institutionalization of the investment process are realities that are irreversible.

The only thing that could reverse them, in my view, is plague and pestilence, another major depression of some kind, or a catastrophic event like a war. This is so because, as I've said already, the barriers to these flows are coming down. The major barriers, which were technology, telecommunications and computing power are coming down and what we're left with are more benign but now really quite important barriers that relate to disclosure requirements and the competitive structure of the participants in these various markets.

So what I'm arguing basically is that I think it would be very short-sighted of us as we go through these hearings not to look at the subject within the context (and the reality) of these various market trends and the structure of the participants in these various markets. As you said yourself earlier on, when you look at Glass-Steagall through the prism of global competitiveness, you may well come up with different conclusions than you did when you looked at it through the more narrow prism of the United States and competition among our three firms.

With respect to the impact of Glass-Steagall, my point basically is that we do feel constrained in terms of our competitiveness, not just here but overseas. As John Heimann knows, there's something called Reg. K that inhibits us in our securities activities overseas. We have national treatment or we're about to get national treatment from the European Community, but there will still be restrictions—United States imposed restrictions on what we can do in the EC.

I did not mean to imply that one of the reasons for the shift in relative importance of the United States securities market is Glass-Steagall. As I think I discussed, there are a lot of these things we've gone over already, like disclosure requirements, and settlement and clearing problems, that to a large part explain the shift in preeminence.

My argument with respect to Glass-Steagall is that keeping all American financial services companies fully competitive in this multi-polar world that we're living in is important and probably crucial for a lot of the macroeconomic reasons that I've just described. We can't change the economic environment. We could, but that's a whole other issue that in fact you brought up—in terms of fiscal policy, among other things.

The realities are there and the question is, do we want everybody to compete and do we want to welcome world class firms? I agree that there are several world class firms that operate here. There were four that were grandfathered, universal banks with AAA ratings that operate here, but they are an exception. They were grandfathered by the International Banking Act of 1978. Everybody else is as restricted in this marketplace as we are in terms of their ability to be involved in the securities business. If you want to be a global market you have to welcome global players on an equal footing. That's the point I'm making. In that context, I think Glass-Steagall is relevant.

But I don't imagine that we're ever going to totally agree on some of these issues.

Senator DODD. I appreciate that. The issue which draws me to the last series of questions really goes back to the first question I raised with Chairman Greenspan and the one that he in fact referred to your testimony, John, in talking about the goals. What are we trying to do here with harmonization and so forth—what is the framework we're talking about?

In fact, to quote you, you say there is a "need to develop a general conceptual framework defining the basic purpose and the need for regulation of financial institutions", and you also feel we should address the issue of whether there should be any attempt at all at harmonization of regulations across different institutions or countries.

I wonder if I could get all three of you to comment on this. It goes to the question of the listings. One of my concerns—and I think you've heard it expressed by others here and I think it's your concern as well—is what Arthur Burns used to talk about as the competition in laxity. If we're seeking the lowest common denominator here, I'm not sure where that takes us in the final analysis.

So, I think the first question is legitimate. Before you get to the question of harmonization, what are the goals we are trying to achieve? What's the framework we should be trying to achieve? Given what you've just said, Mr. MacDonald—and I totally agree with you. I don't know anyone who disagrees—the issue is not debatable any longer whether or not we're going in this direction. That's quite obvious. The question now is, how do we try to influence in a positive way a global structure that makes it possible—not only possible but desirable—for U.S. firms to be competitive and simultaneously provide the kind of confidence that we have historically had as a given—that is, investor confidence, which has been a very important element in the formation of our capital markets. We've seen recently with FSLIC what can happen when problems arise and we're not diligent or vigilant and watching them.

So marrying those concepts is really the challenge in a sense. No one here on this side of the dias disagrees at all with the desire to see us be far more competitive and do a far better job in the coming years of achieving a larger market share. And I don't think there's anyone on your side of the table who thinks that we ought to just throw caution to the wind and allow the system to run wherever it will take us.

Mr. **Heimann**. Mr. Chairman, that's a big question. I should mention to you that you mentioned in the letter of invitation which talked about the Group of 30's clearance and settlement study, which of course is private sector oriented. I'm on the steering committee of the Group of 30 and I would just mention that we are in the process of doing a similar study on supervision of the global capital markets.

Senator **Dodd**. Right.

Mr. **Heimann**. One reality is that we don't have an overview of the capital markets system. In the U.S., we have effective regulation of the securities industry through the SEC. We have solid banking regulators. But as we have heard in other testimony, you have had disintermediation of the commercial banking system as much of its best customers have deserted them for direct access to the global and domestic capital markets. What's to be done about it? What should we be concerned about?

The fundamental answer is that we all want to have the establishment of standards. We want to know that we can provide our services and products in a world in which there are certain minimum standards that protects the public and all users of the financial system. We do not want a system which promotes regul arbitrage atory—seeking the lowest possible common denominator jurisdiction.

But who are to set up those standards and how are those standards to be administered between the public and the private sector? Does this all have to be public sector activity? My answer to that would be no. What is the role of government—the Federal Reserve, SEC, the Comptroller of the Currency—versus the role of the self-regulatory organizations—New York Stock Exchange, the Chicago Board? Internationally you have the same problem. And what about the role of the accountants? What should their role be in the standard-setting system and the enforcement thereof?

It seems to me what we must have is standard-setting. We have it domestically in many nations, but they don't coalesce internationally. Tax laws, regulatory provisions, accounting standards, vary widely. We have to find a system which will permit cooperation in standard setting to grow and flourish in order to protect the users of the system and, simultaneously, incent innovation, make competition fair and equal, and strengthen a safe and sound international financial system.

So what needs to be done is coming together. I heard that Senator Heinz mentioned that he has been talking about an interagency force on capital markets standards and supervision. Those are all steps in the right direction. In effect, we should do that domestically because there are great differences domestically. I need not talk to the Congress of the United States with respect to the Federal

Home Loan Bank Board's views on supervision and safety and soundness versus the reality of what took place.

And then that has to be coordinated internationally, but I think that can be done because we have a history of that through the Cooke Committee which as you know is the banking regulatory subcommittee of the Bank of International Settlements. There is precedent for all of this and, once again, there's an opportunity for the United States to lead the way because we have over the last 50 years done that in the supervisory-regulatory apparatus of the world and we can do that again. But if we don't, others will. Thank you.

Senator DODD. Thank you.

Mr. Hormats.

Mr. HORMATS. Yes. I think we're really getting in to the heart of the attempt to integrate our domestic standard-setting operations with the international process of setting some common standards. I was very positively struck by what Mr. MacDonald said earlier. I think he was in his testimony addressing this issue and I think in a very constructive way. That is, if we recognize that each market is vulnerable to deficiencies in the other markets in terms of settlement procedures, in terms of clearance procedures, in terms of a tightening up or a gridlock in liquidity—if we recognized that there is this mutual vulnerability, then it seems to me, that a very compelling argument exists for moving rapidly to try to come to some common set of standards. This is particularly important because if we do have another crash in the market, given the fact that there is so much more volume today and cross-border volume is growing rapidly, the complexity of the settlement process across borders is becoming increasingly apparent. A crash in the future with a higher degree of volume and a decline of liquidity could be even more serious; and I don't see that we have really made much progress in dealing with that type of issue.

The other thing that makes the timing particularly compelling is that the Europeans internally are setting minimum common standards with respect to accounting, auditing, disclosure, and registration requirements. So that when they get these minimums set, each EC nation will recognize the issuance process of the other, and companies in one will be able to trade on the exchanges of the other. In other words, it will really be one market.

It's just like setting standards for computers or anything else. Once they set those standards among 12 countries, it's going to be very hard to get them to change. We don't have a seat at the table, for obvious reasons. We're not in the Community. But what we need I believe is a parallel effort internationally that proceeds at roughly the same time that the European internal effort is going on, to deal with these things. And it needs to include us. We're working with the Canadians on something very similar. There's a lot of integration between markets. Then you've got the East Asian markets. It was mentioned I think in Alan Greenspan's testimony that Hong Kong was a problem, and caused a lot of secondary problems for us. When you have cross-listings where one market closes up, that has a direct impact on the trading of those same shares in other markets.

We've got to begin to move on an urgent basis, include the G-7, but also bring in Taiwan, Hong Kong, Australia and a number of other countries whose markets are going to be increasingly important both in primary securities and in derivative securities.

So I don't think we have a lot of time. The longer we wait to begin this process in earnest, the greater the risk to the system. And the system is such today that because of the volume and because of the intensity there is a risk and unless we appreciate that risk we probably won't develop the sense of urgency required to deal with it.

Senator DODD. Mr. MacDonald, very quickly. We've got some votes here we're going to have cast and I apologize.

Mr. MACDONALD. Well, I think my colleagues on the panel have said everything that needs to be said.

I would just emphasize one additional point. That is that there is, whether we like it or not, a dramatic difference between the needs of institutional investors and individual investors and we would be making a terrible mistake if we didn't distinguish between those two sets of needs as we go through the process of establishing minimum requirements, for example, with respect to disclosure. In fact, I would argue that a lot of the movement out of some of the U.S. markets in terms of issuance at least is related to not making that distinction quite clear.

We've talked about everything else. There are lots of things that the public sector should be involved and encouraged to participate in and encouraged—Alan Greenspan mentioned the fact that the fact that you're having these hearings and inviting people that are responsible for various pieces of this puzzle to come in and talk to you will add momentum and propel the discussion in the right direction.

And I would encourage continuation of these hearings on Globalization—my ten cents is that more hearings with the right people will further the process. The Group of thirty might be interesting. They are doing outstanding work.

Senator DODD. That's a good idea.

Mr. MACDONALD. And harmonization, whoever gets tagged with harmonization, should follow up to make sure something gets done.

Senator DODD. That's a good suggestion.

Larry, do you want to add some quick points before we vote?

Mr. PRESSLER. I do have some questions which I will not be able to stay for because we're down to about seven or eight minutes and I don't know if we will be coming back or not.

Senator DODD. We've got two votes back-to-back.

Mr. PRESSLER. I have some questions on how the European Community is going to develop their securities regulations. They would be to Mr. Hormats, but we can put them on the record. The European Parliament I'm very interested in how they are going to proceed and how we are interfacing or dialoguing with them. I do have some other questions for the record, but I believe I'm going to have to ask them for the record.

Senator DODD. We will do that. I've already raised that with all three witnesses and I would ask you to respond to Senator Pressler's questions as well as anyone else who may have some.

You're been very, very helpful and I appreciate your point, Mr. MacDonald—I'm glad to hear you say that. I oftentimes wonder is anyone listening. Tomorrow we're going to have—one of the first times, we're going to have a foreign witness before the Banking Committee, someone from Great Britain talking about these issues. I think the idea of having the Group of 30 come in is very, very helpful.

Again, I want to thank all three of you for being as patient to sit through Chairman Greenspan's testimony and then sharing your thoughts. It's very, very helpful.

This subcommittee will stand adjourned until further call of the Chair.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

GLOBALIZATION OF THE SECURITIES MARKETS AND S. 646, THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989

THURSDAY, JUNE 15, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Securities,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Riegle, Heinz, D'Amato, and Pressler.

OPENING STATEMENT OF SENATOR DODD

Senator Dodd. The subcommittee will come to order.

Let me welcome everyone to our second day of hearings on the globalization of the securities markets and S. 646, the International Securities Enforcement Cooperation Act of 1989.

I might begin by saying that we had a very productive day yesterday as we debated the major concerns raised by the globalization of our securities markets. We had excellent attendance as well. The chairman of the Banking Committee who is with us this morning, Senator Riegle, and I think almost every single member of the Banking Committee at one point or another was here yesterday to participate in the hearings. Of course the schedule makes it difficult, but almost everyone was here and we anticipate again this morning excellent participation.

There are a number of questions we explored yesterday and will raise again with the witnesses here today. First, in the era in which the linkages and inter-dependence among separate markets and market participants have created in effect one global marketplace, how do we maintain the safety and efficiency of this global market? How do our financial regulators worldwide communicate and coordinate with each other? And with a system in this country in which the securities, futures and banking systems each have separate regulators, how do we forge a united front in our discussions with other nations? Do our U.S. financial regulators speak with one voice in the international arena?

Chairman Greenspan outlined a number of initiatives that are being undertaken both domestically and internationally, but he agreed as well that much more needs to be done. Our private sector witnesses also urged that more should be done. Indeed, they urged that the pace of our efforts in this area should be accelerated to meet the rapid changes in the marketplace. I might add, I agree with them.

Let me also note that I raised this issue as part of legislation proposed in the last Congress to address the October 1987 market crash. I believed then as I do now that our domestic regulators simply could not confine their efforts to the domestic markets. The provision that I proposed last year would have directed the Federal Reserve, the Securities and Exchange Commission, and the CFTC to work together to coordinate with foreign regulators on market issues that span individual markets and national borders.

Senator Heinz, my colleague and ranking minority member of this subcommittee, announced yesterday that he had a similar interest in pursuing that question. I agree with him that we must question whether, absent this kind of legislative direction, sufficient attention is being given to formulating national policy on these international, intermarket issues.

Second, at our hearing yesterday, we discussed the rapid decline at least in comparative size of our market versus the Japanese market. There are many reasons for this trend, but while we were tempted to blame our loss of dominance on unfair practices abroad or restrictive laws at home, we kept returning over and over again yesterday to the fact that Japan—to paraphrase Willie Sutton—is where the savings are.

In fact, in this morning's paper the indication is that the Japanese savings now is in excess of $5 trillion, that the average Japanese household has a savings of $126,000. Their personal savings rate as a percentage of GNP is four times what ours is. West Germany's is three times the U.S. rate. And I was pleased to see that the Administration, by the way, is considering legislation dealing with IRAs. Senator D'Amato and I in the Tax Reform Act of 1986 tried to retain at least the earlier IRA program or parts of it. We lost that on the Senate floor by one or two votes, as I recall. We now know from studies by Merrill Lynch and others that in fact people were not transferring savings but were creating new savings by that mechanism. I applaud the Administration for looking again at enhancements for IRAs, and would like to work with them, as I know Senator D'Amato would as well. We are anxious to hear your comments on that, Chairman Ruder, when we get to you, as well.

We begin today with another group of distinguished witnesses and I thank them all for coming. I want to say a special thanks to you, Chairman Ruder, our lead witness this morning. You have heard praise from me and other members of this committee about the work that you have done in so many different areas during your tenure. In the international arena we are discussing this morning, you have forged ahead on so many different initiatives. You have worked with your counterparts in dozens of other nations. You have come to us with a legislative proposal to ensure that investors in the global marketplace will be protected, and I applaud you for that.

In this, as in other areas, let me thank you for your tremendous contribution and express the gratitude of this subcommittee.

Let me say also, Mr. Chairman, that I regret to see you leaving this agency and this town. I know that I express the feelings of not only this subcommittee but also the business leaders of our nation who have appreciated your tough and fair regulation. Let me tell you that I know your staff agrees with us as well.

You've had only a couple of years but it's exciting to see someone come forward with ideas and initiatives who wants to make this agency do the job it historically was asked to do. We can only hope that your successor will bring to the job the same energy, the creativity, the deep interest and concern about this nation's future as you have. We welcome you here again before this committee and they haven't named anybody yet, so we're just going to keep you around as long as we can, if that's permissible.

On that note, let me turn to my colleague from Pennsylvania and the rest of the members of the committee for any opening statements, and then we will be delighted to hear from you.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I just want to commend you on not only a very gracious but a very accurate statement of Dave Ruder's value during his tenure as Chairman of the Securities and Exchange Commission. I would like to be associated with your comments wholly and wholeheartedly.

Mr. Chairman, I apologize that I was unable to be present for the entirety of yesterday's hearing. As you know, I had to conduct a workshop for most of the morning and I was unable to return. I appreciate your understanding and I hope I'll be able to return the favor today by being here if you have to be present elsewhere.

Senator DODD. Thank you.

Senator HEINZ. I indicated that the key issues in the globalization process, at least insofar as I am concerned, were competitiveness, capital formation, coordination, and crime or corruption, the last being something we want to prevent and the first three issues being things we need to promote.

And I understand it, the first three issues were discussed at some length during yesterday's hearing, but there was modest or no discussion of international securities enforcement. I must say that the SEC has made a tremendous amount of progress in that area. Chairman Ruder, I want to say that I think the SEC has been a leader on enforcement issues in the world community. I commend you and I congratulate your staff on that.

I was also pleased to note that today's panelists have expressed support for the International Securities Enforcement Cooperation Act of 1989. Yesterday, I understand Senator Riegle, our chairman, stated his willingness to schedule a full committee markup at the earliest opportunity. We are both grateful for that. I know Senator Dodd feels strongly about that issue and I hope we can proceed quickly to provide the SEC with the tools that you, Dave, need to pursue international securities enforcement.

Now as to the first three "C's", one of the things I asked for yesterday of the panelists, and I will do so today as well, was comment on the concept of creating an interagency task force that would be responsible for coordinating on a domestic policy level the rules and regulations which may impact on international competitiveness but which are beyond the expertise or the authority of any one agency to fully consider.

I understand the concept was well received by yesterday's panelists. Lord Camoys in his testimony today acknowledges the importance of coordination within, as well as across, national boundaries. I make that distinction because I am well aware that Senator Dodd has a long-standing interest in coordination issues. In the last Congress, he introduced a measure to create an interagency group to deal with the establishment of international standards.

For example, the SEC, as I understand it, has recently sought additional information of securities holding companies. We understand why you're interested in that information. The SEC does not have sufficient authority to require information from foreign securities holding companies such as Nikko Securities, or a firm domiciled in London. However, there are other regulators currently, such as the Federal Reserve, who by virtue of their authority have a good deal of clout in obtaining information from holding companies about matters within their jurisdiction. I would assume that even today, were such an interagency task force to be formed and carefully directed, that harmonization of what the SEC, for example, is trying to do could be achieved with other regulatory agencies.

So I want to work very closely with Senator Dodd on ensuring coordination. I know he feels strongly about it. We do need both a unified policy here in the United States as well as unified negotiating positions in the international securities area.

Just to close on a personal note, I do want to take this opportunity to praise you, Dave, for your leadership of the SEC over the past two years. The progress the SEC has made on the international front is indeed indicative of the insight and initiative you have shown in tackling a whole host of problems. You have set the very highest standards for the SEC and your staff. I think you've attained them and I wish you well as you return to the academic world, certainly a wiser man, but from my point of view, one who has made an enormous contribution to this country for which we are all deeply grateful.

Mr. RUDER. Thank you.

Senator DODD. Thank you, Senator Heinz.

Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Chairman Dodd.

I want to support the comments made both by Chairman Dodd and by Senator Heinz here, both in terms of the substance of the issues that they have touched upon and also their very warm compliments toward you and the job you've done.

I remember when your nomination was before this committee, as do my colleagues, and there was divided opinion. I think all of us were supporters of yours when the roll was taken. I know I became convinced as we had our conversations back at the beginning that you brought the kind of independence and capacity to really stand up to and step up to an enormous job. I don't think at the time, however, any of us were quite aware of exactly how big the job was about to get, especially with the market crash and other things that happened.

But I must say that I think you've done really an outstanding job under the circumstances, the very difficult circumstances. I know Bill Proxmire is not here now and I know he at the time had some reservations about your nomination, but I think if he were here—and I don't purport to speak for him and can't—but my surmise would be that he, too, would be saying that you have really carried this trust exceedingly well and that any reservations others may have had at the outset I think you've put to rest with your personal leadership and hard work and we are appreciative. These are difficult jobs and demanding times and it's not easy to be a public official in whatever capacity. It's disruptive of family life and other things and I just want to tell you again how much I appreciate and I think it's generally shared by all the members of this committee the work you've given and will continue to give.

My hope would be that—I know this may not be an easy thing to do, but my hope would be that it might be possible for you to remain on the commission in your present capacity until such time as a successor is named and confirmed so that there can really be an orderly transition in the passing of the baton in the best possible way. I know there are a lot of factors, personal and otherwise, that may bear on that, but I would just ask you to give that every consideration because I think this is a very important time and you are in a critical situation and I would hope we could have that kind of orderly change and I think the country would greatly benefit from that if that were possible.

On a separate note, yesterday a number of senators expressed the need—and I think Senator Dodd correctly points out almost every member of the committee was here at one time or another yesterday, which is very noteworthy. But it was generally expressed that there's a need for greater intermarket coordination for both domestic policy reasons and to ensure that our financial institutions and financial service institutions are not disadvantaged in the international arena.

For this reason, Senator Dodd, I think the subcommittee might want to consider codifying the working group of the president consisting of the Secretary of the Treasury, the Chairman of the SEC, the CFTC and the Federal Reserve Board, and require this group to report back to us at least twice a year on the broad range of issues related to the globalization of the capital markets.

Right now we have no formal mechanism in the government for coordinating policy in this area and I think that needs to be changed. I think the onrush of events is so sweeping and so profound and the implications are so vast that I really think we can't afford to fall behind that curve. So to have an orderly mechanism within our own executive branch and a reporting procedure that brings these issues back before us I think would be very helpful and appropriate.

Finally, I would hope that the subcommittee today would examine our witnesses this morning with respect to their experience with London's big bang and the pluses and minuses associated with the rapid deregulation of the financial services marketplace which has recently taken place in England. I think there are probably some valuable lessons there for us to look at.

So with that, I join my colleagues in saying how pleased I am to see David Ruder seated before us today.

Senator **Dodd**. Thank you very much, Senator Riegle. As you note—and Senator Heinz has made reference to the need for regulatory coordination as well. We didn't get very far with the bill last year, but possibly as a part of the legislation that's the subject of the hearings today we might add that element. It's possible as well that could be achieved just through the Administration deciding to do it. It doesn't necessarily require legislation. If they would decide to be more aggressive in this area we could save ourselves a lot of work it seems to me. But clearly something needs to be done.

Senator **Pressler**.

OPENING STATEMENT OF SENATOR PRESSLER

Senator **Pressler**. Thank you.

I join in commending Chairman Ruder for his fine public service. Let me also say that I look forward very much to his testimony this morning.

Mr. Chairman, I wish to commend you for scheduling this hearing on the globalization of the securities markets. I found yesterday's hearing to be very interesting. I am also interested in what is happening in some of the agricultural futures commodities markets in Europe and how that may work out in 1992.

Developments occurring in the securities markets here and abroad during the 1980s clearly indicate the need for us to address the problems dealt with in this and other legislation scheduled for hearing by this subcommittee. It is not an easy task, but one that needs to be undertaken.

Mr. Chairman, I may have some questions for the record, if I should have to go to one of my other committee meetings. We are having a Foreign Relations Committee meeting and a Commerce Committee meeting simultaneously.

Senator **Dodd**. Thank you very much, Senator Pressler.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. Well, Mr. Chairman, I, too, would like to echo our thanks to Chairman Ruder for his service and the manner in which he has conducted himself. He has certainly done a great deal to bring enhanced credibility to the efforts of the SEC.

Mr. Chairman, you came in during a very turbulent time and I think you credited yourself with great distinction. So I'd like to commend you.

Mr. Chairman, I commend you for your work in undertaking these hearings as it relates to globalization of our markets. I might add, as you have pointed out, yesterday we had Chairman Greenspan here and we were talking about the loss of the American savings as a tremendous blow to our economic strength, and with the loss of the IRA plan which you and I worked to retain a diminution in savings when we were just getting working middle class families to begin to utilize that plan and it created billions and billions of dollars in savings and I note with some interest that the administration is considering some kind of an IRA plan to increase savings. It's too bad we had to wait two years and have a loss of what could have been I think a tremendous infusion into the savings.

Then I note that the Japanese savings rates have increased so that the average family saves $126,000, up 11.4 percent they said over the previous year. So if you want to begin to get an idea as to how important savings are and if we're going to be financing debt and we have a deficit, it's better if we're able to finance it internally instead of being dependent upon the world community to help finance the budget deficits that we have, we had better quickly move in that area of using the tax code to encourage savings. That is one of the purposes of the tax code, not just to take revenues to support various government programs, but there are certain social and economic objectives which are enhanced by the proper use.

And I look forward to working with you again, Mr. Chairman, together, and I think we might be able to even count on some other members of this committee, not the least of which is the distinguished senior senator from Pennsylvania, whose name I will not mention, to join with us in that effort. Of course, he has to take on the club then—the finance club, which he's a member of. I say that tongue in cheek.

I think it's terribly, terribly important and I'm encouraged if the administration does come forward with something and I would hope it would be bold and I would hope it would be something that would encourage taxpayers to put as much of their savings aside and really be a stimulation to that because I think it's terribly, terribly important.

With that, Mr. Chairman, I ask that my opening remarks be included in the record as if read in their entirety.

Senator DODD. Thank you very much, Senator D'Amato.

I also have statements from Senators Sasser and Sanford that will be inserted in the record.

[Committee insert of Senators D'Amato Sasser, and Sanford opening statements follow:]

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I welcome this opportunity to hear the testimony of all of today's witnesses. I would also like to take this opportunity to recognize the fine service Chairman David Ruder has rendered during his tenure at the Securities Exchange Commission. Besides providing a steady hand at the Helm during the stock market crash of October 1987, Chairman Ruder has taken some important initiatives.

At yesterday's hearing I mentioned the importance of maintaining the integrity of domestic securities markets in this increasingly global marketplace. Mr. Ruder has taken impertant steps toward improving the SEC's ability to enforce our securities laws against offshore violators. The International Securities Enforcement Act which the full Banking Committee reported last year is a good example of legislation that will promote the integrity of U.S. securities markets and preserve the ability of American companies to raise capital through our domestic exchanges. I commend Chairman Ruder for his initiative in this area.

I would like to make one more observation on the enforcement issue. At least one of yesterday's witnesses cautioned against the risk that our domestic markets might lose some business because our rules and sanctions might be more strict than those of other countries' stock exchanges. While I recognize the risk, I would caution even more strongly against even appearing to seek a low common denominator in enforcement. In the long run the tougher our enforcement is the fairer our markets are. And legitimate investors and traders know that. Short term competitive concerns should never lead us toward competition on laxness. In the long run our vigilant enforcement efforts will prove not only right but profitable.

I am certain that Mr. Ruder agrees with this point and I hope his replacement as chairman, whoever it may be, proves to be his equal in vision and in vigorous enforcement.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I want to again thank you for your efforts in putting these worthwhile hearings together. In addition, I'd like to welcome Chairman Ruder to the Securities Subcommittee.

Indeed, Mr. Ruder, while I have the opportunity I want to complement you on your work at the SEC and wish you well in your return to teaching.

We have not agreed on all the issues in the securities area, but I have always respected your point of view and your intellect.

Moreover, I think we share a concern about the growth of large institutions in the market and whether they may have too short-term a focus. It used to be that investors were largely individuals who took a long-term interest in their stock. Now some 70 percent of stock trades are by institutions that may only hold stock for a matter of hours—if that.

So I appreciate your concern in this area, Mr. Ruder. I think you were on the right track; I hope your successor continues your efforts.

As far as the globalization of securities markets, I am struck by the progress that the Japanese have made in financial services. The Tokyo Stock Exchange is now the largest in the world. The Japanese banks are dominant worldwide and their securities firms are giving ours a run for the money.

This is disturbing since America has always been the financial innovator. Our capital markets have always been the best run and most efficient in the world. Why has this happened? Are our markets too consumed with short term considerations, are they too concerned with merger mania rather than building new companies?

I look forward to the witnesses answers to these and other questions. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you Mr. Chairman. I would like to join my colleagues in adding our sincere thanks to Chairman Ruder for his dedicated service as chairman of the SEC. This may be the last time that you appear before this subcommittee, Chairman Ruder, and I know we all share in wishing you well as you return to academic life and in thanking you for serving the public and our markets and all its participants as head of the SEC.

I would also like to welcome our distinguished panel of witnesses, representing some of the world financial centers integral to the subject of today's hearing, the globalization of the securities markets.

The impact of this financial trend upon the relationship between government and business as well as its potential as an avenue for increased international cooperation, makes today's subject particularly intriguing.

After reviewing the testimonies presented at yesterday's hearings and the report prepared at the request of Senator Dodd by our Congressional Research Service it seems apparent that we must find a regulatory middle ground enabling our financial institutions to be competitive. Moreover, as I noted in my statement inserted into the record yesterday, we must look at the alarming statistical evaluations of our financial institutions' performance world wide, particularly figures showing that for the first time, in 1988, the Tokyo Stock Exchange exceeded volume trading on the New York Stock Exchange and determine what these numbers imply about our financial industry.

Second, it is important to recognize the emerging roles of Japan and a consolidated European market, as proposed beginning in 1992. We must examine how we might work with these entities to eradicate regulatory disparities among countries participating in the international financial markets and to develop the fairest international financial playing field possible.

The globalization of the monetary markets points to the need for greater regulatory coordination, and I am comforted that the committee is considering S.646, the International Securities Enforcement Cooperation Act of 1989.

Again, I commend you for holding this hearing, Mr. Chairman, and with the analogy offered by Mr. MacDonald during his testimony yesterday in mind, I rest assured that today's panel will offer significant insight into how we might best dis-

mantle the world's financial barriers enabling US financial water to integrate itself with other financial water most effectively.

Thank you, Mr. Chairman.

Senator Dodd. Chairman Ruder, we welcome you here this morning. We are anxious to hear your testimony.

STATEMENT OF DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. Ruder. Thank you, Chairman Dodd and Members of the Subcommittee.

I thank you for this opportunity to discuss the globalization of the securities markets and S. 646, the International Securities Enforcement Cooperation Act of 1989. The Commission has submitted two written statements, one on internationalization issues generally and the other on the Enforcement Act, and I request that both be included in the record.

Senator Dodd. Both will be included in their entirety in the record.

Mr. Ruder. As this Subcommittee knows, the securities markets are becoming increasingly internationalized. This internationalization affects the regulatory system administered by the Commission. As dramatically illustrated by the 1987 market break, events in one country's securities market may affect markets in other countries. As a result, we believe the Commission must be conversant with the operations of other markets and must seek to promote international cooperation. In this new environment, the Commission must consider the possible effects of its regulatory decisions upon foreign entry into our markets, upon the ability of U.S. financial service firms to compete abroad, and upon investor protection and opportunity concerns.

The Commission has undertaken important initiatives to further international coordination. In November 1988, the Commission issued a policy statement on the "Regulation of International Securities Markets." I delivered this policy statement at a meeting in Melbourne, Australia of the International Organization of Securities Commissions. In its policy statement, the Commission urged cooperation among the world's securities regulators, while recognizing cultural differences and national sovereignty concerns. The Commission suggested that an efficient regulatory structure for an international securities market system would have several elements. I'm going to read these elements, which are quite complicated, but, I think, are important to give a sense of the depth and breadth of the areas involved.

First, efficient structures for quotation, price, and volume information dissemination, order routing, order execution, clearance, settlement, and payment, as well as strong capital adequacy standards;

Second, sound disclosure systems, including accounting principles, auditing standards, auditor independence standards, registration and prospectus provisions, and listing standards, all of which provide investor protection yet balance costs and benefits for market participants; and

Third, fair and honest markets, achieved through regulation of abusive sales practices, prohibitions against fraudulent conduct, and high levels of enforcement cooperation.

The Commission has been engaged in international cooperation on a multilateral basis. For example, it is an active member of the International Organization of Securities Commissions or "IOSCO.". Indeed, we will be hosting the annual IOSCO conference here in the United States in 1991. The Commission's staff has been particularly active in several of IOSCO's working groups, particularly those groups reviewing such matters as capital adequacy standards, multinational securities offerings, and international accounting standards.

The Commission participates in a number of other multinational organizations. For example, the Commission's staff is assisting the Committee on Banking Regulations and Supervisory Practices, formed under the auspices of the Bank for International Settlements. That Committee is exploring a risk-based capital adequacy approach for the securities positions of banks.

The Commission often works directly with foreign regulators on a bilateral basis to address specific problems. For the past two years, the Commission has participated in meetings with the Federal Reserve Board, the Bank of England, and Britain's Securities Investments Board. These meetings have addressed such matters as capital adequacy standards and information sharing. We have also met on two separate occasions, once in Japan and once in the United States, with the Securities Bureau of the Japanese Ministry of Finance in order to promote interchange of ideas between our Commission and the Securities Bureau.

To facilitate cooperation in the enforcement arena, during the last five years, the Commission has negotiated memoranda of understanding with foreign securities authorities in Brazil, Canada, the United Kingdom, Japan and Switzerland. These memoranda have facilitated mutual cooperation on securities enforcement. We also have informal cooperative relationships with other securities regulators throughout the world.

Earlier this year, the Commission proposed the "International Securities Enforcement Cooperation Act of 1989." This legislation, together with legislation adopted in 1988, is designed to facilitate enforcement cooperation between the Commission and foreign authorities. I'm pleased that you, Chairman Dodd, and Senator Heinz have introduced this legislation as S. 646.

In its effort to promote international cooperation, the Commission, we believe, has played a leading role. In taking this role, the Commission has been motivated both by a desire to improve the operations of the world's securities markets and by its obligation to protect U.S. investors. The Commission stands ready to cooperate with other U.S. agencies, Congress, and foreign regulators to achieve honest and efficient worldwide capital markets.

Thank you.

Senator Dodd. Thank you very much, Chairman Ruder. We appreciate your comments and the synopsis of your statement as well.

[The summary and complete prepared statement of David S. Ruder follows:]

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE GLOBALIZATION OF THE SECURITIES MARKETS

June 15, 1989

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SUMMARY OF THE STATEMENT OF DAVID S. RUDER CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE GLOBALIZATION OF THE SECURITIES MARKETS

June 15, 1989

I. INTRODUCTION

During the 1980s, the world's securities markets expanded dramatically and became increasingly automated and interlinked. As illustrated by the October 1987 market break, events in one country's market affect those in other countries. When promulgating rules and making other regulatory decisions, the Commission must consider the effect its actions will have on the ability of foreign participants to enter our markets and the ability of U.S. financial services firms to compete in other markets.

Recognizing the importance of these issues, the Commission has taken a leadership role in promoting international coordination. The Commission's proposed structure for international cooperation is set forth in its November 1988 Policy Statement on the Regulation of International Securities Markets. The Commission is an active member of the International Organization of Securities Commissions ("IOSCO"), an organization of securities regulators from more than 40 countries. The Commission's staff actively participates in several working groups of IOSCO's Technical Committee. The Commission's staff assists the Committee on Banking Regulations and Supervisory Practices, formed under the auspices of the Bank for International Settlements, on capital adequacy issues, and attends meetings of the Wilton Park Group to discuss enforcement cooperation. The Commission has also worked on a bilateral basis with foreign securities authorities on enforcement and other matters.

In 1988, the Commission proposed legislation, the "International Securities Enforcement Cooperation Act of 1988," portions of which were adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988. In 1989, the Commission proposed similar legislation designed to facilitate cooperation between the Commission and foreign securities authorities in the enforcement of securities laws. Chairman Dodd and Senator Heinz have introduced the Commission's 1989 proposal as S. 646.

II. MARKET STRUCTURE DEVELOPMENTS

In 1988, the Commission issued a release clarifying the U.S. broker-dealer registration requirements for foreign broker-dealers. Proposed Rule 15a-6, developed from previous staff interpretive positions, would provide a limited exemption from the broker-dealer registration requirements for foreign entities that deal with certain non-U.S. persons or with specified U.S. institutional investors.

In its November 1988 Policy Statement, the Commission stated that one of the most important goals in achieving a global securities market is to establish efficient, comparable, and automated clearance, settlement, and payments systems. The Commission generally supports recommendations made by the Group of Thirty, a private sector group that includes international businesspersons and bankers. These nine recommendations are designed to enhance creation of a compatible and efficient worldwide clearance and settlement system.

Other important issues for future coordination of international securities regulation include capital adequacy standards for market participants, information sharing among clearing entities about risk positions of joint members, and the interaction of the securities, options, and financial futures markets. The Commission has proposed legislation to improve coordination among clearing systems for these markets.

The Commission is monitoring developments in the area of after-hours and international automated trading markets and the growth of domestic automated proprietary trading systems. The Commission is also monitoring the program of the European Community to develop a single internal market for services and capital by 1992.

III. REGISTRATION AND DISCLOSURE ISSUES

The Commission is investigating the possibility of developing a multijurisdictional registration system under which issuers would be able to use their own jurisdiction's disclosure documents for offerings in other countries. In 1988, the Commission proposed for comment Regulation S, which would provide safe harbors intended to provide objective procedural standards which, if followed, would assure that offers and sales are outside the United States and therefore not subject to U.S. registration requirements.

The Commission has also proposed Rule 144A, which would provide a safe harbor from the registration requirements of the Securities Act of 1933 for the resale of restricted securities to institutional investors. Development of Rule 144A has been compelled not only by internationalization of the securities markets, but also by the tremendous growth of the private placement market. This rule, as well as the resale safe harbor provisions of Regulation S, should provide increased liquidity in the secondary market for privately placed securities.

The Commission is engaged in cooperative efforts to revise and adjust international accounting and auditing standards in order to increase comparability and reduce costs. The Commission is working with international accounting organizations to develop and harmonize international accounting standards. The Commission's staff is also working with the International Federation of Accountants to revise international auditing guidelines and narrow the differences among auditing standards and procedures.

IV. INVESTMENT MANAGEMENT

In order to meet a growing demand for foreign investments, a number of publicly-offered U.S. registered investment companies recently have been organized to invest in foreign securities. Often the advisers, sub-advisers, and custodians of these funds are located abroad, and most of their portfolio transactions occur abroad. The Commission has entered into informal arrangements with foreign regulators under which information obtained by a foreign regulator through an inspection of investment company operations abroad would be shared with the Commission, and information obtained during a Commission inspection of an investment company's U.S. operations would be shared with the company's foreign regulator.

V. ENFORCEMENT

The Commission has worked both on a bilateral basis and within international organizations to improve coordination of enforcement efforts. The principal issue the Commission confronts in its efforts to police the internationalized securities markets is the need to obtain information located outside of the United States. The Commission has negotiated a number of memoranda of understandings with foreign countries to ensure international assistance and exchange of information. Last year, Congress passed legislation authorizing the Commission to use its subpoena power to obtain information on behalf of foreign securities authorities.

VI. CONCLUSION

In its efforts to promote cooperation on international securities matters, the Commission has been a leader among the world's securities regulators. In taking this role, the Commission has been motivated both by a desire to improve the operations of the world's securities markets and by its obligation to protect U.S. investors. The Commission stands ready to cooperate with other U.S. regulators, with Congress, and with foreign regulators to achieve honest and efficient worldwide capital markets.

TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. MARKET STRUCTURE DEVELOPMENTS 7

  A. Foreign Broker-Dealers 7

  B. Clearance and Settlement 9

    1. Group of Thirty Report 9

  C. Other Areas for Coordination 13

    1. Capital Adequacy Standards 13

    2. Information Monitoring and Sharing 14

  D. After Hours Trading 16

  E. Other Multinational Initiatives 18

III. REGISTRATION AND DISCLOSURE ISSUES 19

  A. Multijurisdictional Registration 20

  B. Regulation S 22

  C. Rule 144A 24

  D. Accounting and Auditing Standards 26

IV. INVESTMENT MANAGEMENT 28

V. ENFORCEMENT 31

VI. CONCLUSION 36

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE GLOBALIZATION OF THE SECURITIES MARKETS

June 15, 1989

Chairman Dodd and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to discuss the globalization of the securities markets.

I. INTRODUCTION

During the 1980s, the world's securities markets expanded dramatically. In 1988, gross transactions by U.S. investors in foreign corporate stocks totalled over $151 billion, down from the record total of over $189 billion in 1987, but still representing almost 9 times the total of such transactions in 1980. Gross U.S. transactions in foreign debt securities totalled $445 billion in 1988, reflecting a more than twelve-fold increase since 1980. U.S. investors' net investment in foreign stocks in 1988 totalled $1.7 billion. Their net investment in foreign debt securities totalled $10 billion. 1/

International markets are increasingly automated and interlinked. For example, the National Association of Securities Dealers, Inc. ("NASD") and the International Stock Exchange in London have initiated a two-year pilot program to

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1/ *Treasury Bulletin* 141 (U.S. Department of the Treasury, March 1989).

exchange quotation information between the NASD's automated quotation system ("NASDAQ") and the ISE. The NASD and the Stock Exchange of Singapore also have initiated a pilot program to exchange quotation information, and trading linkages have been established between U.S. and Canadian exchanges.

The internationalization of the world's securities markets affects the regulatory system administered by the Commission. As dramatically illustrated by the October 1987 market break, events in one country's securities markets may affect those in other countries. As a result, the Commission must understand the operations of other securities markets and seek to promote cooperation among securities regulators in all countries. When promulgating rules and making other regulatory decisions, it must consider the effect its decisions will have upon the ability of foreign participants to enter our markets and the ability of U.S. financial service firms to compete in other markets. These judgments are often complex, and they require the Commission to accommodate competing policy concerns without sacrificing investor protection.

Recognizing the growing importance of these issues, the Commission has taken initiatives to further international coordination. In November 1988, the Commission issued a policy statement on the "Regulation of International Securities Markets," 2/ in which it urged cooperation between the world's

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2/ Policy Statement of the U.S. Securities and Exchange Commission, "Regulation of the International Securities Markets," Securities Act Release No. 6807 (Nov. 21, 1988).

securities regulators, as well as the need to recognize cultural differences and national sovereignty concerns. The Commission suggested that an effective regulatory structure for an international securities market system would include:

1. Efficient structures for quotation, price, and volume information dissemination, order routing, order execution, clearance, settlement, and payment, as well as strong capital adequacy standards;
2. Sound disclosure systems, including accounting principles, auditing standards, auditor independence standards, registration and prospectus provisions, and listing standards that provide investor protection yet balance costs and benefits for market participants; and
3. Fair and honest markets, achieved through regulation of abusive sales practices, prohibitions against fraudulent conduct, and high levels of enforcement cooperation.

I presented the Commission's policy statement at the annual meeting of the International Organization of Securities Commissions ("IOSCO"), which is made up of securities regulators from more than 40 countries. The Commission is an active member of IOSCO, and will host the annual IOSCO conference in 1991. IOSCO's Technical Committee, which is composed of representatives from the most developed markets, reviews regulatory problems related to international securities transactions and proposes practical solutions to these problems. The Commission's staff has been particularly active in several of the Technical Committee's working groups. At a meeting later this month in Montreal, the working group on capital adequacy will consider a report concerning capital adequacy standards for non-bank securities firms. Members of the Commission's staff also are participating in two other working groups. One is studying problems related to multinational offerings of equity securities and the other is attempting to harmonize accounting and auditing standards. The accounting working group and the International Accounting Standards Committee ("IASC"), a private organization supported by approximately 100 accounting bodies from approximately 70 countries, are examining problems in the completeness, specificity, and comparability of international accounting standards.

In the enforcement area, in February 1989, at the Commission's urging, the Technical Committee recommended to IOSCO's Executive Committee a resolution regarding international information sharing. The resolution calls for the negotiation of bilateral and multilateral understandings to facilitate mutual cooperation and assistance in securities law enforcement, and for improved sharing of information and documents between countries.

The Commission participates in a number of other multinational organizations. The Commission's staff is assisting the Committee on Banking Regulations and Supervisory Practices, formed under the auspices of the Bank for International Settlements located in Basel, Switzerland ("BIS"). That Committee is exploring issues related to a risk-based capital adequacy approach for the securities positions of banks. Commission staff also attend meetings of the Wilton Park Group, an informal discussion group convened by the U.K. Department of Trade and Industry and consisting of representatives from ten countries, to discuss methods for improving the exchange of enforcement information among securities regulators.

In addition to the Commission's participation in these multilateral forums, individual Commissioners and staff regularly attend multinational conferences and meet with foreign regulators to discuss coordination efforts. For instance, representatives of the Division of Corporation Finance have been meeting regularly with Canadian authorities on the use of home country disclosure documents. Similarly, representatives of the Division of Investment Management have been discussing with foreign regulators approaches to the cross-border sale of investment company shares. Commissioner Charles Cox serves as the Commission's representative to IOSCO and has attended IOSCO Executive Committee meetings in Europe, Canada, South America, and Australia. During the past two years I have met with securities regulators in Great Britain, Japan, Germany, the Netherlands, Sweden, Canada, Brazil, and Australia, and I have met with regulators from those and other countries both in Washington, D.C., and at IOSCO meetings in Brazil and Australia. Other Commissioners have participated in conferences on international securities regulation in the United States and abroad.

The Commission often works directly with foreign regulators on a bilateral basis to address specific problems. For the past two years the Commission has participated in quadrilateral meetings with the Federal Reserve Board, the Bank of England, and Britain's Securities Investments Board in London and New York, regarding matters of mutual interest, such as capital adequacy standards and information-sharing agreements.

During the last five years, the Commission has negotiated memoranda of understanding ("MOUs") with foreign securities authorities concerning mutual cooperation on enforcement matters. The Commission has entered into such MOUs with the Brazilian Securities Commission, Canadian securities regulators, the United Kingdom Department of Trade and Industry, the Japanese Ministry of Finance, and Switzerland. The Commission and the Securities Bureau of the Japanese Ministry of Finance have established a working group to develop further arrangements for mutual assistance in enforcement matters, as well as procedures for sharing transaction, clearance, and customer information under our MOU.

In 1988, the Commission proposed legislation, the "International Securities Enforcement Cooperation Act of 1988," portions of which were adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988. In 1989, the Commission proposed similar legislation designed to facilitate cooperation between the Commission and foreign securities authorities in the enforcement of securities laws. Chairman Dodd and Senator Heinz have introduced the Commission's 1989 proposal as S. 646.

The Commission has been developing internal procedures to coordinate and organize its international securities regulatory activities. In 1987 it submitted to Congress a staff report on the internationalization of the securities markets. In 1988 it named an Associate Director for International Affairs in the Commission's Division of Enforcement in order to enhance efforts to negotiate enforcement MOUs. Increased staff resources have also been committed to the Office of International Corporate Finance in the Division of Corporation Finance in order to deal effectively with international registration and disclosure issues and projects. Since March of 1988, the various Commission divisions have been participating in biweekly coordinating meetings to discuss international activities, and in March 1989 the Commission inaugurated the International Release series to publish Commission releases on international topics. 3/

II. MARKET STRUCTURE DEVELOPMENTS

A. Foreign Broker-Dealers

With the growing interest in international portfolio diversification, U.S. investors, and in particular large institutions, have sought efficient access to foreign securities markets. An important component of this access is the use of foreign broker-dealers to obtain analyses of foreign securities and to execute transactions in foreign exchange and dealer markets. In response to these developments, in 1988 the

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3/ International Series Release Nos. 1-94 (March 28, 1989).

Commission issued a release clarifying the U.S. broker-dealer registration requirements for foreign broker-dealers. 4/ The release included a staff interpretive statement regarding the applicability of U.S. broker-dealer registration requirements to foreign entities engaged in securities activities involving U.S. investors, and sought comments on this statement in anticipation of a final Commission interpretive statement. The release also included proposed Rule 15a-6, developed from previous staff interpretive positions, which, if adopted, would provide a limited exemption from the broker-dealer registration requirements for foreign entities that deal with certain non-U.S. persons or with specified U.S. institutional investors. In particular, this exemption would allow foreign broker-dealers to contact large U.S. institutional investors directly, without registration in the United States, so long as any resulting trades were executed through a U.S. registered broker-dealer.

The Commission subsequently published a comment letter from the American Bar Association that suggested incorporating major sections of the staff interpretive statement in the exemptive rule. These sections included an exemption for unsolicited trades, a limited exemption for research provided through registered broker-dealers, and an exemption for foreign broker-dealers contacting other U.S. institutions if a registered representative of a U.S. broker-dealer participated in and monitored those contacts. The Commission determined that this

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4/ Securities Exchange Act Release No. 25801 (June 14, 1988).

comment merited serious consideration. A final version of Rule 15a-6 will be considered by the Commission during the summer of 1989.

B. Clearance and Settlement

One key international securities regulation problem is the wide disparity in settlement periods and degrees of automation among the world's markets. The current lack of coordination among clearance and settlement systems in major world markets increases the costs and risks of global securities trading. The United States has developed an automated depository and book entry clearance and settlement system which is efficient, but which can be improved in important ways. Other mature markets are in varying stages of developing automated clearing and settlement systems. Ultimately, the Commission hopes that all countries will establish fully automated clearance and settlement systems permitting paperless book entry movement of all broker-dealer and institutional securities positions.

1. Group of Thirty Report

In its November 1988 Policy Statement, the Commission stated that one of the most important goals in achieving a global securities market is to establish efficient, comparable, and automated clearance, settlement, and payments systems. In 1989, the Group of Thirty, a private sector group that includes international businesspersons and bankers, made nine recommendations designed to enhance creation of a compatible and efficient worldwide clearance and settlement system. The

Commission supports the Group of Thirty recommendations with some minor reservations. The Group of Thirty's recommendations would facilitate competition among markets and cross-border movements of capital and would enhance investor confidence in the securities markets.

The recommendations contained in the Group of Thirty's report are:

1. By 1990, all comparisons of trades between direct market participants (i.e., brokers, broker-dealers, and other exchange members) should be accomplished by T+1.

2. Indirect market participants (such as institutional investors, or any trading counterparties which are not broker-dealers) should, by 1992, be members of a trade comparison system which achieves positive affirmation of trade details.

3. Each country should have an effective and fully developed central securities depository, organized and managed to encourage the broadest possible industry participation (directly and indirectly), in place by 1992.

4. Each country should study its market volumes and participation to determine whether a trade netting system would be beneficial in terms of reducing risk and promoting efficiency. If a netting system would be appropriate, it should be implemented by 1992.

5. Delivery versus payment should (DVP) be employed as the method for settling all securities transactions. A DVP system should be in place by 1992.

6. Payments associated with the settlement of securities transactions and the servicing of securities portfolios should be made consistent across all instruments and markets by adopting the "same day" funds convention.

7. A "Rolling Settlement" system should be adopted by all markets. Final settlement should occur on T+3 by 1992. As an interim target, final settlement should occur on T+5 by 1990 at the latest, save only where it hinders the achievement of T+3 by 1992.

> 8. Securities lending and borrowing should be encouraged as a method of expediting the settlement of securities transactions. Existing regulatory and taxation barriers that inhibit the practice of lending securities should be removed by 1990.
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> 9. Each country should adopt the standard for securities messages developed by the International Organization for Standardization [ISO Standard 7775]. In particular, countries should adopt the ISIN numbering system for securities issues as defined in the ISO Standard 6166, at least for cross-border transactions. These standards should be universally applied by 1992.

Current practices in the U.S. securities markets conform to, or are moving toward substantial conformity with, most of the Group of Thirty's recommendations. Central depositories permitting book-entry delivery, institutional participation in confirmation and affirmation systems, trade netting, delivery versus payment, rolling settlements, and securities lending to support settlement are all firmly established practices in the U.S. securities markets. Substantive progress toward earlier trade comparison also is being accomplished in the United States through the efforts of the New York Stock Exchange, the NASD, the National Securities Clearing Corporation, and other self-regulatory organizations. The Commission understands that, within nine to twelve months, a period that meets the Group of Thirty's target date, the substantial majority of inter-dealer transactions in over-the-counter, NASDAQ, New York Stock Exchange, and American Stock Exchange securities will be compared by T+1.

Moreover, due to this progress in earlier trade comparison, the question of earlier settlement already has been under active consideration. Earlier trade comparison would require that the clearing agency guarantees of trade settlement occur sooner, and that clearing agencies be exposed to market risk for a longer period of time. For this reason, earlier trade comparison would necessitate earlier settlement or other means to protect the clearing agencies from increased market exposure, such as marking to the market or higher clearing fund contributions.

The question of standardized identification numbering systems also is under discussion among U.S. securities professionals. By recommending use of the International Securities Identification Number, or "ISIN," but limiting the recommendation to cross-border trades, the Group of Thirty implicitly has acknowledged that substantial investment has been made in the infrastructure of domestic systems. Nevertheless, an interim solution such as a conversion facility should not preclude discussion of whether outright adoption of ISIN is the best longer-term solution to the problem of inconsistent securities identification numbering systems.

Implementation in the United States of the Group of Thirty recommendation that all settlements be made in same day funds raises significant issues that the Commission believes warrant further study and discussion. Although market participants generally agree that conversion to same day funds settlement would create long-term advantages and efficiencies, the recommendation raises several significant concerns, including whether the Fedwire system and other electronic funds transfer systems could handle an increased volume of large dollar transactions late in the day. In addition, same day funds settlement would reduce the amount of available time for clearing agencies and their participants to resolve temporary liquidity problems. Clearing agencies thus would be required to monitor more closely the financial condition of clearing members.

The Commission plans to assist in efforts to evaluate and implement the Group of Thirty recommendations. With regard to the three most far reaching aspects of the recommendations for U.S. securities markets, the Commission will continue to monitor progress toward next day comparison and earlier settlement periods for all stock markets, and will cooperate with banking regulatory agencies to address the same day funds settlement suggestion.

C. Other Areas for Coordination

Some of the most important items for future coordination of international securities regulation not contained in the Group of Thirty report include capital adequacy standards for market participants, information sharing among clearing entities about risk positions of joint members, and the interaction of the derivative markets.

1. Capital Adequacy Standards

Adequate capital requirements for market participants are basic to the safe functioning of all securities markets. A working group of IOSCO's Technical Committee has been studying the issues related to capital adequacy for non-bank securities firms and is currently exploring the suggestion that international risk-based capital adequacy standards should be adopted. Additionally, the Committee on Banking Regulations and Supervisory Practices 5/ has designated a working group on position risk for traded securities. This working group is exploring various issues related to a risk-based capital approach for the securities positions of banks. At the group's request, the Commission has designated a representative to assist the group in its deliberations.

2. Information Monitoring and Sharing

Another important component of sound market linkages is a procedure whereby clearing agencies monitor information about the financial and operational condition of participants in multiple markets and share that information with clearing agencies in other markets. U.S. clearing agencies serving the equity and equity options markets have formed the Securities Clearing Group ("SCG") to accomplish this objective. The SCG members have agreed to work toward a system of sharing settlement, margin, and position information about joint members. As international clearing linkages develop and mature, a similar international initiative also should be undertaken.

In the international context, the provision of information may serve as a method for reconciling conflicting regulatory

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5/ The Committee was formed under the auspices of the BIS.

requirements, which can be unnecessarily burdensome. For example, the Commission has entered into an agreement with certain regulators in the United Kingdom which provides that they will waive their capital adequacy requirements for U.S. broker-dealers that have branches in the United Kingdom, if the Commission provides them with certain information. The Commission has agreed to notify U.K. regulators if it becomes aware that a particular broker-dealer's financial or operational condition is impaired, and U.K. regulators have agreed to notify the Commission if they become aware that a U.K. branch of a U.S. broker-dealer has a substantial problem. The Commission also is discussing with foreign securities authorities the exchange of information with respect to affiliates of regulated entities.

Coordination among stock markets and markets trading options and financial futures is important for the development of sound clearance, settlement, and payments systems. The Commission has proposed legislation to improve coordination among clearing systems for securities, options, and futures. The Commission's proposal was introduced by Chairman Dodd and Senator Heinz as S. 648. This legislation would also require the Commission and the Commodity Futures Trading Commission to report to Congress within two years on the progress toward linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, options, and futures. Finally, the legislation would encourage further private sector initiatives to resolve these problems. For example, the American Bar

Association's Advisory Committee on Settlement of Market Transactions already is reviewing the need for harmonization of state law concerning the transfer and pledge of securities.

D. After Hours Trading

Many multinational companies currently list their stock on major exchanges around the world even though the trading is normally concentrated in the company's home market. Because much of the overseas trading may occur after the domestic markets have closed, some domestic markets are exploring the possibility of extending their trading hours. For example, the Midwest Stock Exchange has proposed a late trading session so that members can execute portfolio trades which they now execute in London. 6/ The Chicago Mercantile Exchange and the Chicago Board of Trade also are developing electronic systems for trading products listed in their markets, in order to compete effectively with developing overseas markets. The Commission also understands that the New York Stock Exchange has considered the possibility of creating a system for after-hours trading, but that the exchange does not currently believe enough trading activity exists to justify such a system.

Finally, the Commission has encouraged the development of certain proprietary trading systems that provide quotation dissemination and, in some instances, trading across markets. For example, the Instinet system, owned by Reuters Holdings PLC,

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6/ Securities Exchange Act Release No. 26887 (June 2, 1989).

offers automated quotation dissemination and execution services to both domestic and international subscribers. 7/ One of Instinet's features is a "crossing network" that permits institutions to trade entire portfolios of securities with one another on an after-hours basis. In 1986, subject to certain enumerated conditions, the Commission staff issued a no-action letter to Instinet with respect to the non-registration of the Instinet system as a national securities exchange, registered securities association, and registered clearing agency. 8/

Related to the growth of after hours and international automated trading markets is the growth of domestic automated proprietary trading systems. The Commission has recently voted not to object to a staff no-action position regarding a proprietary system for trading options on U.S. Treasury notes, has temporarily registered a clearing agent for that system, and has proposed Rule 15c2-10 designed to provide a means of regulating such systems. 9/ Developments in this area presage

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7/ In addition, recent newspaper reports indicate that the NASD is considering implementation of a system that would permit pre-dawn trading of 200-300 of the most actively traded OTC stocks, including several dozen stocks that would be traded in direct competition with the International Stock Exchange. As yet, the Commission has not received a proposed rule change from the NASD with respect to the planned system.

8/ *See* letter from Richard G. Ketchum, Director, Division of Market Regulation, to Daniel T. Brooks, Cadwalader, Wickersham & Taft, counsel for Instinet Corporation (August 8, 1986).

9/ The Commission is in litigation with respect to its actions on the proprietary trading system. *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, Nos. 89-1084 and 89-1449 (7th Cir.).

ultimate consideration of the proper means of regulating both proprietary and non-proprietary international automated trading systems.

E. Other Multinational Initiatives

The Commission is monitoring the program of the European Community ("EC") to develop a single internal market for the EC's services and capital by the end of 1992. The EC's Second Banking Directive has particularly interested financial regulators in this country. Moreover, this directive is important to the Commission because much of international securities trading is conducted by banks, and regulated by bank supervisory authorities. The directive is designed to establish criteria under which a member state may authorize the establishment of a bank, and would provide that once it is authorized by a member state, the bank may establish operations in any other member country. As originally drafted, the directive would have required that non-EC countries grant access to EC banks before banks in those countries could be eligible for a single banking license in the EC. A draft EC Investment Services Directive, which would apply to the establishment of securities firms in the EC, contains substantially similar reciprocity provisions. The United States opposed this reciprocal approach, and in April the Commission of the EC recommended, with respect to the Second Banking Directive, that the EC move to a scheme that closely approximates the "national treatment" standard favored by the United States. Under the EC's revised approach, non-EC banks would be permitted to obtain a single license if the non-EC country treats EC banks in the same way as domestic banks, and if EC banks are given effective market access in the non-EC country. While the Commission is encouraged by the recent proposed modifications, it is not yet clear whether or how the new treatment is to be applied and whether similar proposals will be made for the directives affecting securities transactions.

The Commission also is monitoring the efforts of multinational organizations to study the international financial markets. For example, the Commission's staff has participated in a number of studies of the financial markets prepared by the Organization for Economic Cooperation and Development ("OECD").

III. REGISTRATION AND DISCLOSURE ISSUES

In the registration and disclosure area, three factors have driven the Commission's initiatives: (1) the desire of U.S. investors to diversify their portfolios on a global basis; (2) the desire of issuers to be able to choose to raise capital outside the United States without concern that they will violate U.S. securities registration requirements; and (3) the concern that unnecessary restrictions on the free flow of capital are increasing costs to issuers and investors, as well as impairing the efficient allocation of capital.

The Commission has accommodated foreign private issuers by developing a separate registration and reporting system for such issuers, and by making some adaptations in disclosure requirements. 10/ However, the U.S. securities laws continue to discourage foreign issuers from directly entering the U.S. market. U.S. investors thus have been forced to purchase the securities of these foreign issuers offshore, generally in the secondary market, in which case they are denied the pricing advantage provided in the initial offering.

As noted in its November 1988 Policy Statement, the Commission believes that its goal in addressing international disclosure and registration problems should be to minimize regulatory impediments without compromising investor protection. The Commission also believes that it must seek to accommodate foreign law and practice, but avoid compromises that would give foreign issuers an undue advantage over domestic issuers in the U.S. markets. Consistent with these views, the Commission has responded to the foregoing concerns with three major initiatives: multijurisdictional registration, Regulation S, and Rule 144A.

A. Multijurisdictional Registration

Differences in disclosure requirements, accounting principles, and auditing standards are impediments to multijurisdictional offerings. As discussed above, the Commission's staff is participating in multinational efforts to

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10/ See Securities Act Release No. 16371 (Nov. 29, 1979). Accommodations were made in disclosure requirements for management remuneration, transactions with management, and segment reporting. Additionally, in 1982, the Commission adopted an integrated disclosure system for foreign issuers enabling them to use periodic reports previously filed in the United States in connection with public offerings made here. Securities Act Release No. 6437 (Nov. 19, 1982).

achieve international agreements on internationally acceptable principles and standards in these areas. Such agreements would make possible the establishment of a mutually acceptable worldwide disclosure regime.

In the interim, the Commission is developing a multijurisdictional registration system whereby issuers can use their own jurisdiction's disclosure documents for offerings in other countries. The Commission first addressed the multijurisdictional registration concept in 1985, when it issued a concept release that requested public comment on ways to accommodate multinational securities offerings and to harmonize the prospectus disclosure standards and securities distribution systems of the United States with those of other countries. 11/ The United Kingdom and Canada were identified as the most likely partners in any initial effort because of their frequent use of our markets and the similarity of their accounting principles and disclosure requirements. 12/

Comment was sought on two possible approaches: a reciprocal approach and a common prospectus approach. Under the reciprocal approach, each of the jurisdictions would accept the disclosure documents prepared in the issuer's domicile. Under the common prospectus approach, the jurisdictions would agree to use common disclosure standards. The majority of commentators favored the

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11/ Securities Act Release No. 6568 (Feb. 28, 1985).

12/ *Id*.

reciprocal approach, primarily because of the ease of implementation.

The Commission's staff subsequently discussed with the staffs of the Ontario and Quebec Securities Commissions establishment of a system of multijurisdictional disclosure. Substantial progress has been made, and, during the summer of 1989, the Commission expects to consider an initial multijurisdictional registration experiment with Canada. If adopted by the Commission, the experiment likely will cover offerings by substantial issuers, rights and exchange offerings by a larger class of issuers, and some cash tender offers. The regulations and forms developed in this experiment would provide a foundation for a multijurisdictional disclosure system that could be expanded to encompass a wider class of issuers and additional jurisdictions. This effort will be directed to those jurisdictions whose different disclosure systems apply similar accounting principles and auditing standards and provide similar basic disclosure to investors. The problem is to provide a means of protecting U.S. investors and permitting the sale of foreign securities in U.S. markets without giving foreign issuers an undue advantage over U.S. companies in U.S. markets.

B. Regulation S

The Commission also is examining questions regarding the application of U.S. registration requirements to overseas securities offerings. While the registration provisions of Section 5 of the Securities Act 13/ are broad enough to require

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13/ 15 U.S.C. 77e.

registration of any securities offering in which there is some contact with the United States, the Commission recognized in 1964 that the law need not be applied to the offer and sale of securities outside the United States to non-U.S. investors in a manner that resulted in the offering coming to rest outside the United States. 14/ However, under that articulation, application of the registration requirements depended on whether the purchasers were U.S. persons. As a result, U.S. investors have been precluded from participation in many primary overseas securities offerings by foreign companies. In addition, the demarcation of the appropriate reach of the registration provisions has been developed on a case-by-case basis, resulting in a lack of clear standards for determining which transactions require registration. While these problems have existed for years, they have become more critical with the development and maturity of major markets offshore and the huge growth of transnational investment.

In 1988, the Commission proposed Regulation S for comment. 15/ Regulation S states the general principle that the U.S. securities laws are intended to protect the U.S. capital markets, so that offers and sales in the United States, whether to foreign or domestic persons, should be registered unless otherwise exempt. In contrast, offers and sales outside the

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14/ See Securities Act Release No. 4708 (July 9, 1964).

15/ Securities Act Release No. 6779 (June 10, 1988).

United States should not be subject to U.S. registration requirements.

Regulation S would provide safe harbors intended to provide objective procedural standards which, if followed, will assure that the offers and sales are outside the United States and therefore not subject to U.S. registration requirements. The procedures set forth are those deemed necessary to protect against an indirect public offering in the United States through the mechanism of offshore transactions.

The Commission received 95 comment letters regarding proposed Regulation S. The staff is revising the proposal in response to the comments received. In light of the number of revisions being made, the staff plans to recommend that the Commission repropose Regulation S early in the summer of 1989.

C. Rule 144A

On October 25, 1988, the Commission published for comment Rule 144A, which would provide a safe harbor exemption from the registration requirements of the Securities Act for the resale of restricted securities to institutional investors. 16/ Development of Rule 144A has been compelled not only by internationalization of the securities markets, but also by the tremendous growth of the private placement market. In 1981, $18 billion worth of securities were privately placed in the United

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16/ Securities Act Release No. 6806 (Oct. 25, 1988).

States. In 1987, such placements totalled approximately $139 billion. 17/ In 1988, approximately $202 billion were raised in this private placement market, representing approximately 43 percent of total corporate financing in the United States that year. 18/

Rule 144A is intended to provide a framework in which qualifying institutional resales can be freely undertaken. This rule, as well as the resale safe harbor provisions of proposed Regulation S, should provide increased liquidity in the secondary market for privately placed securities. The potential increase in liquidity could significantly lower the discount commonly associated with private placements, which could in turn attract an increasing number of issuers, including foreign issuers, into the private placement market.

Foreign issuers that previously may have been concerned about compliance costs and liability exposure associated with registered public offerings in the United States or that may have been concerned about the financing costs inherent in placing restricted securities may find U.S. private placements more financially attractive under Rule 144A. Direct participation by foreign issuers in the U.S. capital market would reduce the costs borne by U.S. institutional investors by enabling them to invest

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17/ IDD Information Services. This is a conservative figure because it only includes private placements involving intermediaries. Accordingly, it includes neither direct placements by issuers nor swaps.

18/ *Id*.

in a diversified worldwide portfolio without leaving the U.S. securities markets. The staff is revising the rule proposal in response to the significant number of public comments received. Due to the substantial nature of the revisions, the staff plans to recommend that the Commission repropose Rule 144A early in the summer of 1989.

D. Accounting and Auditing Standards

The continuing trend toward internationalization will increase the need for, and the benefits to be derived from, mutually agreeable international accounting principles and auditing guidelines. Such standards would reduce the regulatory burdens resulting from current disparities among the various national standards. Accordingly, the Commission, along with securities regulators and members of the accounting profession throughout the world, is engaged in efforts to revise and adjust international accounting and auditing standards in order to increase comparability and reduce costs.

In an effort to address accounting differences, the Commission's staff is working with international accounting organizations such as IOSCO and IASC 19/ to review international accounting standards. IASC is addressing international accounting standards that are incomplete or lack sufficient specificity, and it seeks to reduce the number of accounting options permitted under some of the standards. Where options

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19/ *See* discussion of IASC, *supra*, p.4.

cannot be eliminated, IASC plans to specify one method as the benchmark (or "preferred") method for international filings.

At its November 1988 meeting in Copenhagen, IASC approved publication of an Exposure Draft of proposed amendments to the international accounting standards for public comment. 20/ This proposal represents the first phase of IASC's project to address the question of accounting options. The Exposure Draft addresses issues concerning revenue recognition, business combinations, investments, retirement benefits, and foreign currency. The Exposure Draft was released on January 1, 1989, and has an exposure period of nine months.

In addition to the Commission staff's participation in IASC and IOSCO initiatives, the Financial Accounting Standards Board ("FASB"), under the oversight and with the encouragement of the Commission, also has indicated a desire to participate in the development and harmonization of international standards. A Board member acts as the Board's representative to the IASC and is a member of the IASC consultative group, which meets regularly with the IASC to discuss IASC's projects. 21/

The Commission staff also is working with the International Federation of Accountants ("IFAC") to revise international

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20/ International Accounting Standards Committee, "Comparability of Financial Statements, Proposed Amendments to International Accounting Standards 2, 5, 8, 9, 11, 16, 17, 18, 19, 21, 22, 23, and 25" (Jan. 1, 1989).

21/ Address by Dennis R. Beresford, Chairman of the Financial Accounting Standards Board, Meeting of the International Accounting Standards Committee (June 23, 1988).

auditing guidelines. Auditors in different countries are subject to different independence standards, perform different procedures, gather varying amounts of evidence to support their conclusions, and report the results of their work differently. The Commission staff, as part of an IOSCO working group, is participating in a project by IFAC to revise international auditing guidelines and to narrow these differences.

With the increased internationalization of the securities markets, there will be a need to minimize the differences in accounting principles and auditing guidelines. The Commission, the FASB, and the accounting profession, therefore, will continue to devote substantial attention to international accounting and auditing issues.

IV. INVESTMENT MANAGEMENT

An increasing number of investors, both individual and institutional, are developing an interest in foreign investments. In order to meet the growing demand, a number of publicly-offered U.S. registered investment companies recently have been organized to invest in foreign securities. These so-called international funds are organized in the United States and registered under the Investment Company Act of 1940. Often their advisers, sub-advisers, and custodians are located abroad, and most of their portfolio transactions occur abroad.

As of December 1988, there were 126 mutual funds registered with the Commission that invest their assets, in whole or in part, in foreign securities. The net asset values of these funds totalled $20.7 billion. These figures do not include closed-end funds, mutual funds that concentrate their investments in the securities of companies that mine precious metals, or unit investment trusts. If these other types of investment companies were included, assets of investment companies investing abroad would exceed $47.6 billion as of December 1988.

While the Commission supports increased foreign investment opportunities for U.S. citizens, it has been concerned about the difficulties in monitoring the activities of U.S. funds investing abroad. At issue is the Commission's ability to inspect funds with operations abroad to determine whether they are in compliance with the federal securities laws. To alleviate this concern, the Commission has encouraged foreign regulators to enter into informal information sharing arrangements with the Commission. Under these arrangements, information obtained by a foreign regulator through an inspection of investment company operations abroad would be shared with the Commission, and information obtained during a Commission inspection of an investment company's U.S. operations would be shared with the company's foreign regulator. The Commission also has explored the possibility of conducting joint inspections with foreign regulators. The Commission's Memorandum of Understanding with the Brazilian Securities Commission provides for such an arrangement.

In spite of the growing interest in foreign securities, regulatory barriers in the United States and foreign markets have limited the extent to which investment company products can be sold across national borders. Section 7(d) of the Investment Company Act of 1940 22/ prohibits an investment company that is not organized under the laws of the United States from publicly offering securities in the United States unless it obtains a Commission exemptive order. Section 7(d) further requires that the Commission make certain findings before an order can be granted. In particular, the Commission must find that it is both legally and practically feasible to enforce effectively the provisions of the Act. This standard has proven very difficult to meet. By contrast, a foreign money manager can freely enter the U.S. market simply by registering with the Commission as an investment adviser and paying a $150 fee. While a foreign adviser is required to furnish a consent to service of process with the Commission, it need not maintain an office or staff in the United States. The approximately 200 foreign advisers currently registered with the Commission are free to establish and manage mutual funds in the United States on the same terms and conditions as U.S. advisers. Many foreign money managers act as advisers or sub-advisers to U.S. investment companies that invest all or part of their portfolios in foreign securities.

U.S. funds have had difficulty selling their shares abroad because of restrictions imposed in certain countries (which in some cases are stricter than those applied to domestic funds in those countries). Moreover, in order to reach a sufficiently

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22/ 15 U.S.C. 80a-7(d).

large market abroad, it is necessary to comply with the different requirements of various countries. Also, some countries have imposed currency and other restrictions that provide a disincentive to foreign securities investments by citizens of those countries.

In 1985, the European Community took a major step toward the creation of a common market for investment company products when it adopted a directive for certain "undertakings for collective investment in transferable securities" ("UCITS"). The directive establishes a minimum regulatory standard and requires mutual treatment of these products. Member countries are permitted to regulate these products in areas not covered by the directive. The twelve member nations are required to conform their laws by October 1989 to the UCITS Directive. Once the UCITS Directive is implemented, the European Community may seek to negotiate bilateral agreements with non-member countries, such as the United States, along the same lines. The Commission is currently studying the UCITS Directive and its implementation by the member states to determine its potential impact on investors and the investment company industry.

V. ENFORCEMENT

The internationalization of the securities markets has prompted the Commission to develop initiatives in the enforcement area which are consistent with its mandate to preserve fair and honest markets in the United States, while maintaining the United States as a major securities trading center. The Commission has taken a leadership role in developing international understandings to enhance cooperation among regulators. The Commission has worked both on a bilateral basis and within international organizations to develop a systematic approach for coordinating enforcement procedures to address complex frauds when they arise.

The principal issue which the Commission confronts in its efforts to police the internationalized U.S. securities markets is the need to obtain information that is located outside the United States. The Commission has faced significant hurdles in obtaining overseas information.

In the early 1980's, in an attempt to secure foreign-based evidence that was withheld on the basis of foreign bank secrecy laws, the Commission sometimes resorted to the federal courts to compel the production of this information. Although effective in particular cases, this unilateral approach was time consuming and expensive, and occasionally strained international relations. In part due to success in U.S. courts, the Commission was able to begin a dialogue with foreign securities and other law enforcement authorities and to develop informal case-by-case understandings which facilitated the production of foreign-based information. The ad hoc nature of this approach highlighted the need for more formal mechanisms that would guarantee the availability of assistance and foster cooperation.

A 1982 Memorandum of Understanding between the United States and Switzerland was the first such formal mechanism. The

Swiss MOU provided the Commission with unprecedented access to Swiss bank trading records. Of equal importance, the MOU provided a new formula for approaching evidence-gathering issues: bilateral understandings negotiated by the Commission, tailored to meet urgent enforcement problems and to address the foreign country's particular concerns.

After the Swiss MOU, the Commission negotiated increasingly complex MOUs with other countries. In 1986, the Commission entered into MOUs with the United Kingdom's Department of Trade and Industry and the Japanese Ministry of Finance. These MOUs provide assistance for a wide range of cases, but limit that assistance to that which can be provided through the "best efforts" of the regulators. In other words, each authority has agreed to provide the other with information already in its possession or which can be obtained from third parties without the exercise of compulsory process. This limitation was, in part, a consequence of restrictions on the Commission's ability to use its subpoena power to assist foreign authorities at the time the understandings were negotiated.

Based upon Commission proposals, Congress passed legislation last year 23/ authorizing the Commission to use its subpoena power to obtain information on behalf of foreign securities authorities. This legislation permits the Commission to implement more comprehensive agreements. Indeed, the Commission

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23/ Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

has entered into MOUs that cover virtually the entire range of cases that could arise under the federal securities laws, and provide for a full range of assistance, including the use of subpoena power. The Commission has signed two such agreements, one with the Brazilian Securities Commission, and the other with the British Columbia, Ontario, and Quebec Securities Commissions, securities regulators of the three largest Canadian provinces. Additional MOUs similar to these agreements are under negotiation.

While Commission efforts have been primarily directed to the negotiation of bilateral agreements, the Commission also has been an active participant in multilateral settings. In 1986, for example, the IOSCO Executive Committee adopted a Commission sponsored resolution on cooperation which mandated that members who thereafter ratified the resolution should agree to exchange information relating to securities matters. This resolution has been ratified by twenty-three securities regulators, including the Commission. In 1989, the Commission proposed another resolution, calling for members to negotiate comprehensive MOUs on information sharing similar to those the Commission has negotiated with the Canadian securities regulators and the Brazilian Securities Commission. This resolution, which was endorsed by the members of IOSCO's Technical Committee, will now be submitted to the entire IOSCO membership for consideration.

The Commission also has organized and participated in international meetings concerning cooperative efforts to combat international fraud. In October 1988, the Commission sponsored a meeting to discuss various foreign and U.S. investigations of boiler room operations in Europe that allegedly are related to Thomas C. Quinn, a subject of several prior Commission actions who has been under arrest in France. The two-day meeting, attended by representatives of eleven countries and numerous agencies from the U.S. government, resulted in a framework for cooperation among the participants. Earlier this month, as part of the Commission's efforts to address fraud in the penny stock market, the Commission sponsored a training program for both domestic and foreign regulators and prosecutors at which strategies for investigating and prosecuting such cases were discussed.

The Commission also has developed a dialogue with the major participants in the international securities markets through its interaction with the Organization for Economic Cooperation and Development. The Working Group on International Investment Policies of the OECD Committee on International Investment and Multinational Enterprises is undertaking, at the Commission's initiative, a program to explore extraterritorial evidence gathering in the securities field.

The Commission believes that its efforts to facilitate information sharing have laid the groundwork for more effective regulation of international securities markets. The Commission's information sharing agreements, which were stimulated by problems encountered in insider trading cases, now provide assistance in all types of securities cases. While insider trading cases have gained more publicity in recent years, the Commission's efforts are directed toward comprehensive agreements for assistance in the full range of cases that will be confronted as the markets continue to internationalize.

The Commission plans to continue to negotiate bilateral understandings on the exchange of information and to develop cooperative working arrangements with securities regulators abroad. The Commission also plans to work within multilateral organizations such as IOSCO and the OECD to foster additional cooperative enforcement efforts.

VI. CONCLUSION

In its efforts to promote cooperation on international securities matters, the Commission has been a leader among the world's securities regulators. In taking this prominent role, the Commission has been motivated both by a desire to maintain the importance of the United States as a financial center and by its obligation to protect U.S. investors. It believes that the high level of investor protection in the United States has contributed to the strength of U.S. capital markets. The Commission believes its efforts to achieve international regulatory cooperation will play a major role in larger U.S. efforts to eliminate overseas trade barriers. It stands ready to cooperate with other U.S. regulators, with Congress, and with foreign regulators to achieve honest and efficient worldwide capital markets.

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE U.S. SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING S. 646, THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989

June 15, 1989

SUMMARY

The internationalization of the world's securities markets is one of the most significant developments in modern finance. This development requires international cooperation to prevent securities fraud. Last year Congress passed an important piece of legislation intended to promote international cooperation. Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988 authorized the Commission to provide investigative assistance to foreign securities authorities. That provision had been introduced as part of the proposed "International Securities Enforcement Cooperation Act of 1988," submitted to Congress by the Commission on June 3, 1988.

The Commission believes that additional statutory authority would further its efforts to promote international cooperation in enforcement of the securities laws. Accordingly, it supports S. 646, the proposed International Securities Enforcement Cooperation Act of 1989, introduced by Chairman Dodd and Senator Heinz on March 17, 1989.

This legislation contains the three provisions of the Commission's June 1988 proposal that were not enacted. The Commission continues to strongly support these three provisions. They are:

(1) a provision exempting confidential documents received from foreign authorities from disclosure requirements under the Freedom of Information Act or other laws;

(2) a provision making explicit the Commission's rulemaking authority to provide nonpublic documents and other information to domestic and foreign authorities; and

(3) a provision granting the Commission explicit authority to bar, suspend, or place limitations on securities professionals based upon the findings of a foreign court or foreign securities authority.

In addition, the Commission is seeking the enactment of two provisions that were not included in the June 1988 proposal. These provisions would:

(1) authorize the Commission and self-regulatory organizations, after an opportunity for a hearing, to deny any person who has been convicted of a felony membership or association with a member or to place conditions upon membership or association; and

(2) authorize the Commission to accept reimbursement for expenses incurred in providing assistance to a foreign securities authority.

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CONCERNING S. 646, THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989

June 15, 1989

Chairman Dodd and Members of the Subcommittee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission (the "Commission") in support of S. 646, the proposed International Securities Enforcement Cooperation Act of 1989, introduced by Chairman Dodd and Senator Heinz on March 17, 1989. As this Subcommittee knows, the internationalization of the securities markets is one of the most significant recent developments in finance. Although this development has many beneficial effects, it has made the enforcement of the U.S. securities laws more difficult and more costly.

In its last session, Congress passed an important piece of legislation intended to aid in international cooperation to assist and enhance the enforcement of securities laws. Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988 1/ amended Section 21(a) of the Securities Exchange Act of 1934 to permit the Commission to provide investigative assistance to foreign securities authorities. That provision had been introduced as part of the proposed "International Securities

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1/ Pub. L. No. 100-704, 102 Stat. 4677.

Enforcement Cooperation Act of 1988," submitted to Congress by the Commission on June 3, 1988. On June 29 and August 3, 1988, I testified on behalf of the Commission before this Subcommittee and the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, respectively, in hearings concerning the June 1988 proposal. The testimony on those two occasions described Commission initiatives to obtain cooperation from other countries in the pursuit of evidence needed to investigate potential violations of our securities laws, and our work with international organizations to promote international cooperation in the securities enforcement field. 2/

Although Congress enacted the portion of the June 1988 proposal authorizing investigative assistance, three other proposed provisions were not enacted. The Commission continues to support strongly these three remaining provisions of the Commission's June 1988 proposal which are included in the current legislation. They are as follows:

(1) a provision exempting confidential documents received from foreign authorities from disclosure requirements under the Freedom of Information Act or other laws;

(2) a provision making explicit the Commission's rulemaking authority to provide nonpublic documents and other information to domestic and foreign authorities;

2/ See Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs on S. 2544, 100th Cong., 2d Sess., at 28-45 (1988)[hereinafter cited as "Senate Testimony"]; Statement of Chairman Ruder, Securities and Exchange Commission, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning the International Securities Enforcement Cooperation Act of 1988, at 9-24 (August 3, 1988).

(3) a provision granting the Commission explicit authority to censure, revoke the registration of, or impose employment restrictions upon securities professionals based upon the findings of a foreign court or foreign securities authority.

In addition, the Commission is seeking the enactment of two provisions that were not included in the June 1988 proposal. The first would authorize the Commission and self-regulatory organizations to prohibit any person who has been convicted of a felony from becoming a member or becoming associated with a member or to place conditions upon such membership or association. The second would provide authority for the Commission to accept payment or reimbursement for expenses incurred in providing assistance to a foreign securities authority.

I. INTRODUCTION AND SUMMARY

As explained in our testimony last year, the Commission has made significant strides in recent years in addressing enforcement problems raised by the internationalized marketplace. 3/ The Commission has successfully pursued several major fraud cases in which the U.S. securities laws were violated by persons operating from abroad or using foreign bank accounts, including, for example, SEC v. Dennis Levine 4/ and SEC v. Stephen Wang and Fred Lee 5/.

3/ See Senate Testimony, at 30-36. That testimony also describes the Commission's usual means of obtaining evidence and other assistance from foreign authorities when no MOU or informal arrangement exists.

4/ 86 Civ. 3276 (S.D.N.Y.)(RO).

5/ 88 Civ. 4461 (S.D.N.Y.)(RO).

A. Confidentiality of Foreign Documents

Much of the progress in international enforcement cooperation has been made through negotiation of memoranda of understanding, or "MOUs," with foreign securities authorities. Among other things, these bilateral agreements provide for mutual investigative assistance. The Commission has entered into MOUs with securities authorities in Switzerland, the United Kingdom, Japan, three Canadian provinces, and Brazil. 6/ These MOUs are important tools in international enforcement, and the Commission anticipates that it will be enter into additional MOUs with other countries.

In certain cases, however, the Commission has been unable to reach agreement on MOUs with foreign authorities because of conflicts between the confidentiality requirements of foreign nondisclosure laws and the Freedom of Information Act ("FOIA"). Some foreign laws require that documents provided to the Commission must, under certain circumstances, be kept confidential unless disclosure is necessary or required in the course of a Commission investigation or enforcement action. The Commission, of course, must comply with the FOIA and other laws which, in many cases, preclude withholding documents provided by foreign authorities from the public.

6/ The Commission also can obtain some investigative assistance from certain countries through mutual legal assistance treaties, the Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, *opened for signature* March 18, 1970, 23 U.S.T. 2555, T.I.A.S. No. 7444, and by informal agreements. *See* Senate Testimony, at 31, n.1 and accompanying text.

Section 2 of the proposed legislation would eliminate this potential conflict by amending Section 24 of the Exchange Act to enable the Commission to maintain the confidentiality of certain evidence received from foreign securities authorities. This provision is crucial to the Commission's ability to negotiate additional MOUs. In order to facilitate the cooperation of foreign authorities in providing the Commission with investigative assistance, the Commission urges Congress to exempt documents furnished to the Commission from disclosure if the foreign authority represents in good faith that the disclosure of the documents would violate the confidentiality requirements of its country's laws.

B. Providing Information to Foreign Authorities

Section 2(b) of the legislation also would make explicit the Commission's rulemaking authority to provide documents and other information to foreign authorities as well as to domestic authorities. The Commission currently grants access to its investigative files to certain securities enforcement entities, including domestic and foreign securities authorities and self-regulatory organizations. However, certain provisions of the federal securities laws arguably limit the disclosure of certain nonpublic documents. In view of the significance of this issue to the Commission's efforts to cooperate with both foreign and domestic securities officials, the Commission believes that it would be appropriate to make the Commission's authority explicit.

C. Sanctions on Securities Professionals

Sections 3 through 6 of the bill would amend the Exchange Act, the Advisers Act, and the Investment Company Act to permit the Commission, after an opportunity for a hearing, to exercise discretionary authority to utilize the findings of a foreign court or foreign securities authority in order to censure, revoke the registration of, or impose employment restrictions upon securities professionals registered to do business in the United States. The Commission already has such authority as to illegal or improper activity in the United States under these acts. Certain provisions of the federal securities laws also have been used to support the imposition of limitations on activities of securities professionals based upon the findings of a foreign court as to illegal activity abroad. In view of the rapid internationalization of the markets and the Commission's new authority to investigate on behalf of foreign securities authorities under Section 21(a)(2) of the Exchange Act, it would be appropriate to make explicit and to add to the Commission's existing authority the discretionary ability to utilize the findings of a foreign court or securities authority to sanction securities professionals in the United States.

The Commission believes that it should have this discretionary authority, exercisable after a hearing, to suspend, bar, or place appropriate restrictions upon securities professionals who have made false filings with foreign authorities; who have been convicted of certain crimes by foreign courts; who have been enjoined by a foreign court from committing securities law violations; who have violated foreign securities laws; or who have aided and abetted such violations. Such authority would be a necessary and appropriate supplement to the Commission's authority to place limitations on securities professionals based on violations of U.S. laws. The Commission expects that, at least in part as a result of the enforcement assistance that the Commission will provide to foreign authorities pursuant to newly enacted Section 21(a)(2) of the Exchange Act, securities professionals will be subject to more aggressive enforcement efforts by such foreign authorities. It would be ironic and inconsistent with the Commission's mandate to protect investors if the Commission were to provide assistance leading to a finding that a securities professional had violated foreign securities laws substantially similar to U.S. laws, but could not prevent that securities professional from conducting business in the U.S. securities markets. The provisions of Sections 3 through 6 would protect against such a result.

Section 3(b) of the legislation would expand the class of persons subject to "statutory disqualification" pursuant to Section 3(a)(39) of the Exchange Act. It would expand the grounds on which the Commission or a self-regulatory organization ("SRO") could deny a person membership in, participation in, or association with a member of, the SRO in two ways. First, it would include certain foreign disciplinary actions within the definition. Second, it would amend subparagraph (F) of that section, which by cross reference to Section 15(b)(4) of the Exchange Act makes persons convicted of specified felonies and misdemeanors subject to a statutory disqualification. The amendment would add "any other felony" to the list of crimes that subject a person to the statutory review process. This provision would permit the Commission and the SROs to review the proposed association of persons who have been convicted of crimes that are not currently specified, such as taking of property, assault, murder, and drug trafficking. This amendment would not automatically exclude every person convicted of a felony from the securities business. Rather, it would permit the Commission and SROs to consider the facts and circumstances surrounding a particular felony conviction and to impose appropriate safeguards to protect the U.S. markets and investors from unreasonable risks.

D. Reimbursement

Finally, in certain cases, foreign securities authorities have expressed a willingness to reimburse the Commission for travel, subsistence, and other necessary expenses incurred by the Commission and its employees in carrying out investigations for the foreign authority pursuant to Section 21(a)(2) of the Exchange Act or in providing other assistance. The Commission has been unable to accept such payments, however, because federal appropriations law prohibits federal agencies from accepting funds from outside sources absent specific statutory authority.

The proposed legislation would amend Section 4(c) of the Exchange Act to permit the Commission to accept reimbursement.

The Commission believes that it has made great progress in developing mechanisms and approaches for policing the internationalized U.S. markets. The International Securities Enforcement Cooperation Act of 1989 provides authority necessary to build on this progress. Enactment of the legislation would provide a critical vehicle for enhancing our efforts to maintain the integrity of the U.S. securities markets.

II. THE PROPOSED LEGISLATION

A. Legislation authorizing the Commission to assure confidential treatment of documents furnished to the Commission by foreign securities officials

The legislation would amend the securities laws to permit the Commission to assure confidential treatment for records provided to the Commission by foreign securities authorities. The Commission currently cannot provide such assurances of confidentiality because of its disclosure obligations under the FOIA and civil discovery rules. The legislation would permit the Commission to withhold from disclosure documents furnished to the Commission which might otherwise be required to be disclosed by the FOIA or under a third-party subpoena, if the foreign authority represents in good faith that the disclosure of such documents would be contrary to its country's laws. The Commission would, however, still be obligated to disclose such documents to Congress. The documents would also be subject to discovery requests in any enforcement action brought by the

United States or the Commission, absent a separate basis upon which to withhold them.

In entering into MOUs with the Commission, authorities in foreign countries have committed themselves to obtaining and providing the Commission with documents, some of which otherwise would be kept confidential. These authorities are willing to permit public use of these documents for the purpose of investigating and prosecuting securities law violators. However, they have expressed concern about the disclosure of such documents when the Commission decides not to prosecute a particular matter.

The Commission's disclosure obligations under the FOIA are the same for records obtained from foreign securities authorities as they are for records obtained from other sources. Accordingly, the documents must be disclosed under the FOIA unless they fall within a specified FOIA exemption. Likewise, such documents generally must be disclosed pursuant to a third-party subpoena served on the Commission unless a legal privilege or other defense is available. Because of these disclosure obligations, foreign securities authorities have expressed concerns about providing the Commission with information relevant to ongoing investigations. They also have stated that their own domestic laws preclude them from entering into agreements with the Commission unless the Commission is able to fulfill the confidentiality requirements of the foreign country's laws. In some cases, MOU negotiations have been frustrated by the

Commission's inability to provide assurances that documents and testimony transmitted to the Commission by foreign authorities will be kept confidential.

Section 2 of the Commission's legislative proposal would establish an exemption from disclosure under the FOIA or other applicable law. Adoption of this provision will enhance the Commission's ability to obtain otherwise unobtainable confidential documents from foreign countries for law enforcement purposes. Unless an appropriate FOIA exemption is created, many foreign securities authorities may be unwilling or unable to enter into MOUs with the Commission. More generally, the Commission believes that principles of comity make it appropriate to exempt from disclosure confidential documents obtained from a foreign government if those documents could not be disclosed under the laws of that foreign government.

The exemption is not unlimited. The proposed Section 24(d) would supersede the FOIA 7/ by authorizing the Commission to withhold from disclosure documents obtained from a foreign securities authority only if the foreign authority has in "good faith" represented to the Commission that public disclosure of such records would be contrary to the laws of the foreign

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7/ Certain statutes have been found to preempt or supersede the FOIA. *See, e.g.*, *Ricchio v. Kline*, 773 F.2d 1389, 1392 (D.C. Cir. 1985)(holding that the FOIA was preempted by the Presidential Recordings and Materials Preservation Act, the sole purpose of which is "to preserve" and "to provide access to" a certain specific body of records). By superseding the FOIA, the statute would avoid the need by the Commission to rely on a FOIA exemption in order to withhold confidential information from disclosure.

country. 8/ The term "foreign securities authority," as defined in Section 3(a)(50) of the Exchange Act, which was enacted as part of the Insider Trading and Securities Fraud Enforcement Act passed last year, includes government agencies and self-regulatory organizations which "administer" or "enforce" the securities laws.

B. Legislation granting the Commission rulemaking authority to permit access to its files by persons, both domestic and foreign, engaged in securities law enforcement and oversight

The Commission's Rules of Practice authorize the Director of the Division of Enforcement to provide access to non-public materials in the Commission's investigative files to domestic and foreign governmental authorities, self-regulatory organizations, and other specified persons. 9/ In addition, Rule 2 of the Commission's Rules Relating to Investigations authorizes designated members of the Commission staff to "engage in discussions" concerning the nonpublic materials with the persons specified in Rule 30-4(a)(7). 10/ These access rules have

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8/ Absent a "good faith" standard, the statute might bind the Commission to follow the dictates of a foreign government. The "good faith" requirement would permit the Commission to inquire into the legitimacy of the foreign government's non-disclosure request.

9/ Rule 30-4(a)(7), 17 C.F.R. 200.30-4(a)(7).

10/ 17 C.F.R. 203.2. Other relevant rules include: Rule 2.5(b) of the Commission's Rules On Informal and Other Procedures, 17 C.F.R. 202.5(b), which states that the Commission may "grant requests for access to its files made by domestic and foreign governmental authorities, self-regulatory organizations such as stock exchanges or the [NASD], and other persons or entities"; Administrative Regulation 19-1(1)(b), (continued...)

frequently provided the basis for making nonpublic materials available to other enforcement agencies and to SROs engaged in prosecuting securities law violations.

The Commission's access rules are longstanding. However, Section 24(b) of the Exchange Act, 15 U.S.C. 78x(b), enacted in 1975, makes it unlawful "for any member, officer, or employee of the Commission to disclose to any person other than a member, officer or employee of the Commission, or to use for personal benefit, any information contained in any application, statement, report, contract, correspondence, notice or other document filed with or otherwise obtained by the Commission (1) in contravention of the rules and regulations of the Commission under [the FOIA], or (2) in circumstances where the Commission has determined pursuant to such rules to accord confidential treatment of information." Section 24(b) was intended to make all requests for confidential treatment of information subject to the FOIA

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persons or entities"; Administrative Regulation 19-1(1)(b), SECR 19-1(1)(b), which provides that "the prohibition[s] against the use of non-public information or documents" imposed by various Commission rules do "not apply to the use of such materials as necessary or appropriate by members of the staff in pursuing Commission investigations, examinations or in the discharge of other official responsibilities"; Administrative Regulation 19-1(1)(c), SECR 19-1(1)(c), which sets forth a policy approving the use of non-public materials and the furnishing of "such assistance as may be required for the effective presentation or prosecution of a case" in circumstances where the Commission refers matters to the Justice Department or grants access to its files to any federal, state or foreign government authority; and the Commission's policies and procedures concerning the "routine uses" of systems of records in the Commission's possession that are covered by the Privacy Act. See, e.g., 41 Fed. Reg. 41550 (September 22, 1976) and 54 Fed. Reg. 24454 (June 7, 1989).

rules. 11/ There is nothing in the legislative history of Section 24(b) suggesting that Congress intended to undermine the Commission's access program. Nevertheless, it could be argued that the language of Section 24(b) precludes disclosure of documents that are determined under the FOIA to be confidential.

In most situations, the Commission receives an access request *before* the staff makes a confidential treatment determination, and Section 24(b) is not, therefore, at issue. On occasion, however, Section 24(b) can pose an obstacle to compliance with an access request.

Additional problems with the Commission's access program may arise from other statutory provisions. Section 210(b) of the Advisers Act bars the staff from making information relating to a Commission investigation public if the information was obtained pursuant to that Act, unless the Commission expressly authorizes such disclosure (with exceptions for public hearings and disclosure to Congress). Section 45(a) of the Investment Company Act restricts disclosure of certain non-public documents received by the Commission pursuant to that Act, except insofar as disclosure is made to federal or state government officials.

To make clear the Commission's authority to grant access to its files to domestic and foreign authorities, the Exchange Act

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11/ Prior to the 1975 Amendment, the Commission provided confidential treatment under both the FOIA rules and under Section 24(a), which at that time prescribed standards for granting confidential treatment to information *filed* with the Commission. The Amendments were intended to end the latter procedure. *See* S. Rep. No. 94-75, 94th Cong., 1st Sess. 137, *reprinted in* 1974 U.S. Cong. & Admin. News 179, 314.

should be amended to provide the Commission with explicit authority in this area.

The proposed amendment would add new subsection (c) to Section 24 of the Exchange Act to grant the Commission rulemaking authority to define categories of persons to whom access may be given. As a result, the Commission will have flexibility in adjusting its access rules in the future. In addition, by specifying that the Commission may provide access to foreign persons, the Commission's authority as to this matter will be made explicit. 12/ The provision as to confidentiality of records would strengthen the Commission's ability to refuse to provide records to persons who will make the records public for purposes other than those stated in an access request. 13/

The proposed legislation provides that it would not alter the Commission's responsibilities under the Right to Financial Privacy Act. 14/

12/ By including the phrase "notwithstanding any other provision of law," the amendment will supersede Section 45(a) of the Investment Company Act and Section 210(b) of the Investment Advisers Act.

13/ Commission policy now requires that the person making the access request state the purposes for which the requested information will be used and certify that no public use will be made of the information except for the purposes specified. These or similar procedures would continue to be used after the legislation is enacted. In the international context, where the Commission has entered into MOUs, such MOUs delineate the public uses that can be made of information which the Commission provides pursuant to the access program.

14/ 12 U.S.C. 3401 *et seq*. *See* Section 2(b) of the proposed legislation, which would add new Section 24(e) to the (continued...)

C. Legislation authorizing the Commission to impose sanctions on securities professionals for violations of foreign laws or for committing felonies

1. Overview

One likely result of efforts by foreign securities authorities to strengthen their securities law enforcement will be an increase in the number of enforcement or disciplinary proceedings brought against securities professionals, such as brokers, dealers, and investment advisers, who operate in the United States as well as abroad. Indeed, such actions may result at least in part from the assistance provided to foreign authorities by the Commission pursuant to newly enacted Section 21(a)(2) of the Exchange Act. The Commission, however, currently does not have explicit authority to impose administrative sanctions against securities professionals based upon foreign findings of illegal or improper activities overseas (although, as discussed below, the Commission has some authority in this area). The proposed legislation would provide that the Commission could, in its discretion, after an opportunity for a hearing, impose sanctions on a securities professional who has been found to have engaged in misconduct abroad when, had the order or finding of violation been made in a U.S. proceeding, the professional would have been subject to a Commission disciplinary proceeding. This amendment would give the Commission discretion to bring an administrative proceeding based on foreign misconduct, just as it

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14/(...continued)
Exchange Act. See also H.R. Rep. No. 95-1383, 95th Cong., 2d. Sess. 247 (1978).

has discretion to bring such actions based on domestic misconduct. Sections 3 through 6 of the bill would amend Sections 15(b)(4) and 3(a)(39) of the Exchange Act; Section 9(b) of the Investment Company Act; and Section 203(e) of the Advisers Act to provide the Commission with this express authority.

2. Specific concerns

a. Sanctions based upon foreign convictions

U.S. broker-dealers, investment advisers, and investment companies have increased significantly their activities in foreign markets. 15/ The activities of foreign professionals in the U.S. markets also are likely to increase. 16/ As a result,

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15/ *See* Internationalization of the Securities Markets, Report of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, dated July 27, 1987, at Chapter VII. With regard to investment companies, the report states that there has been a dramatic increase in the number of U.S. investment companies that emphasize foreign securities in their portfolios and that it has become more common for investment companies registered in the U.S. to issue their securities in foreign markets. As of January 1988, there were 154 registered investment companies of all types that concentrate their portfolio securities in foreign securities. These funds, which are widely held by U.S. investors, use foreign broker-dealers to execute portfolio transactions, foreign custodians to hold portfolio securities and foreign advisers to help manage their portfolios. With regard to broker-dealers, major foreign markets usually facilitate entry by granting national treatment to U.S. securities firms. France has substantially increased access to its markets by foreign firms, *id*. at V-3, and the Tokyo Stock Exchange recently increased the number of seats allocated to foreign firms. In addition, affiliates of U.S. broker-dealers now engage in significant market-making activities in London. *Id*. at V-21.

16/ *See id*. at I-14-16; II-78-90. The report indicates that over 120 investment advisers from 20 countries have (continued...)

the Commission is likely to confront a growing number of securities professionals who have been disciplined abroad for illegal or improper activities working or seeking to work in this country.

The Commission currently has substantial authority to curtail the securities activities of certain convicted criminals and other wrongdoers for illegal or improper conduct in this country. Under Sections 15(b)(4) and (b)(6) of the Exchange Act, the Commission may censure, limit the activities, functions, or operations of, suspend for up to twelve months, or revoke the registration of any broker or dealer, or bar from association with any broker or dealer, any person: who is found to have violated the federal securities laws, rules, or regulations thereunder; who is convicted of a "felony or misdemeanor" within

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16/(...continued)
registered with the Commission. With regard to investment companies, in 1984, the Commission transmitted a legislative proposal to Congress that would amend Section 7(d) of the Investment Company Act to give the Commission greater flexibility in permitting foreign investment companies access to the U.S. securities markets. Although this proposal never was introduced in either House of Congress, the Commission anticipates renewed interest in a legislative proposal to amend Section 7(d). In addition, the Commission is considering the possibility of reciprocal arrangements between the United States and foreign nations with respect to multinational offerings of mutual fund securities. Finally, recently-adopted Rule 6c-9 will facilitate the offering of foreign bank securities in the U.S. Investment Company Act Rel. No. 16093 (Oct. 29, 1987).

With regard to broker-dealers, about 150 foreign firms had established branches in the United States as of 1987; for their part, U.S. firms had over 250 branches in foreign countries, excluding Canada and Mexico. Id. at Chapter V, Appendix B-66 (remarks of James M. Davin, Vice-Chairman, NASD).

the preceding ten years involving specified crimes; who willfully has filed a false or misleading statement in any registration statement or report filed with the Commission; or who has willfully aided and abetted a violation of any portion of the federal securities or commodities laws. Such a person also is subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. 17/ Sections 203(e) and (f) of the Advisers Act provide the Commission with disciplinary authority as to investment advisers and persons associated with registered investment advisers, similar to that in Sections 15(b)(4) and (6) of the Exchange Act. 18/

In addition, Section 9(a) of the Investment Company Act generally prohibits a person convicted of a securities-related crime or subject to a securities-related injunction from serving as an employee, officer, director, member of an advisory board,

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17/ As a result, when such a person seeks to become associated with a member of an SRO, that SRO and the Commission have the opportunity to give special review to the person's employment application or to restrict or prevent reentry into the business where appropriate for the protection of investors. See Section 15A(g)(2) of the Exchange Act and Rule 19h-1 thereunder.

18/ Section 15(b)(6) of the Exchange Act and Section 203(f) of the Investment Advisers Act authorize the Commission to limit the activities of a person associated or seeking to become associated with a broker-dealer or investment adviser if the Commission finds that the person has committed any of the acts or has been convicted or enjoined as designated in Section 15(b)(4) or Section 203(e). As a result, any addition to the Commission's authority under Section 15(b)(4) and Section 203(e) will, by implication, expand the Commission's authority under Section 15(b)(6) and Section 203(f).

investment adviser, or depositor of a registered investment company, or principal underwriter for any registered open-end company, unit investment trust, or face-amount certificate company. The automatic statutory disqualification in Section 9(a) is supplemented by the Commission's authority under Section 9(b). Under Section 9(b), the Commission may prohibit a person from serving in any of the capacities cited in Section 9(a) or as an affiliated person of a registered investment company's investment adviser, depositor, or principal underwriter if the person willfully has caused a false or misleading statement to be made in any registration statement or report filed with the Commission or if the person has willfully violated or aided and abetted a violation of any provision of the federal securities or commodities laws.

Although the provisions discussed above do not mention the Commission's authority to impose sanctions based on foreign misconduct, certain of the provisions can be so applied. In particular, Sections 15(b)(4)(B) of the Exchange Act, 203(e)(2) of the Advisers Act, and 9(a)(1) of the Investment Company Act refer to a "felony or misdemeanor" conviction for specified crimes. Neither the statutes nor their legislative histories specify that the crime or conviction must take place in the United States. 19/ On at least one occasion, the Commission has

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19/ Investment Trusts and Investment Companies: Hearings Before a Subcommittee on the Senate Committee on Banking and Currency, 76th Cong. 3d Sess. 7, 31, 559 (statement of Honorable Charles F. Adams) (1940); Investment Trusts and (continued...)

used its authority under Section 15(b)(4)(B), to revoke the U.S. registration of a Canadian broker-dealer who was convicted of crimes in Canada involving the purchase or sale of securities. 20/ Likewise, under Sections 15(b)(4)(C) of the Exchange Act and 203(e)(3) of the Advisers Act, the Commission may impose sanctions based upon a securities-related injunction entered by a "court of competent jurisdiction," and, under Section 9(a)(2) of the Investment Company Act, such an enjoined person's association with a registered investment company is limited. These statutes are not explicitly limited to injunctions entered by U.S. courts. 21/

As to other provisions, however, this authority needs to be clarified and, in some cases, expanded. First, the Commission's authority to impose sanctions on a professional 22/ and to restrict association with a registered investment company 23/

19/(...continued) Investment Companies: Hearings Before a Subcommittee on the House of Representatives Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 13, 46, 97 (1940). As to Section 15(b)(4)(B) of the Exchange Act (originally Section 15(b)(5)(B)), see H. Rep. No. 1418, 88th Cong., 2d Sess. 21 (1964).

20/ In the Matter of R.P. Clarke & Co., 10 S.E.C. 1072 (1942). See also L. Loss, Securities Regulation 1303, n. 51 (2d ed. 1961) (citing R.P. Clarke decision and stating that the Commission may impose sanctions under Section 15(b)(4)(B) based upon a conviction in a foreign court).

21/ See L. Loss, Securities Regulation at 1305 (2d ed. 1961) (stating that a "court of competent jurisdiction" as set forth in Section 15(b)(4)(C), may include a foreign court).

22/ Section 15(b)(4)(A) of the Exchange Act and Section 203(e)(1) of the Investment Advisers Act.

23/ Section 9(b)(1) of the Investment Company Act.

for a misstatement in an application for registration or report filed with the Commission does not extend to misstatements made to foreign regulatory authorities. Second, the Commission's authority to impose sanctions on the professional 24/ or to restrict association with a registered investment company 25/ for willful violation of the U.S. securities and commodities laws does not extend to violations of foreign securities laws. Finally, the Commission's authority to impose sanctions on professionals for aiding and abetting a violation or failing reasonably to supervise a person subject to the professional's control in violation of the U.S. securities laws 26/ and to restrict association with a registered investment company of personnel who are found to have aided and abetted these violations 27/ does not extend to activities that violate foreign securities and commodities laws. The legislation would provide the Commission with authority to act in each of these circumstances.

In addition, as to the provisions under which the Commission does have authority to impose sanctions, the legislation would make such authority explicit and would preclude certain challenges which might be possible under the existing

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24/ Section 15(b)(4)(D) of the Exchange Act and Section 203(e)(4) of the Investment Advisers Act.

25/ Section 9(b)(2) of the Investment Company Act.

26/ Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(5) of the Investment Advisers Act.

27/ Section 9(b)(3) of the Investment Company Act.

statutes. In particular, Section 15(b)(4)(B) of the Exchange Act, Section 203(e)(2) of the Advisers Act, and Section 9(a)(1) of the Investment Company Act refer to convictions for a "felony or misdemeanor" as the basis for a Commission sanction. A securities professional who was convicted in a country that does not define crimes as "felonies" or "misdemeanors" might challenge the Commission's authority under these sections. A Commission administrative sanction also might be challenged when the foreign offense for which the securities professional was convicted is not one of the exact offenses specifically covered by the statutory provisions. As discussed below, the proposed legislation would undercut such defenses by providing for Commission sanctions based upon foreign convictions for crimes "substantially equivalent" to those listed in the statute. The legislation also would foreclose the potential argument that the statutory provisions that allow the Commission to impose sanctions on professionals who have been enjoined from acting in specific capacities, such as underwriters or investment advisers, 28/ do not apply to persons whose profession is not so defined in a foreign country. The proposed amendments would resolve the potential difficulties posed by differences in employment terms by permitting sanctions based upon an injunction entered against a professional who performs a "substantially equivalent" function to the activities currently listed in the statute.

28/ Section 15(b)(4)(C) of the Exchange Act; Section 203(e)(3) of the Investment Advisers Act; and Section 9(a)(2) of the Investment Company Act.

The proposed legislation would also create a "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act, when a foreign securities authority or foreign court makes findings of illegal or improper conduct.

The Commission's action against a securities professional would not be automatic. The statutory procedure for imposing sanctions for foreign misconduct would be the same as that currently in place for imposing sanctions for domestic misconduct. The Commission would provide the securities professional with notice and an opportunity for a hearing before imposing a sanction. The securities professional would thus have an opportunity to present evidence on his or her own behalf, in order to demonstrate that the imposition of sanctions would not be in the public interest. In addition, if the professional makes a persuasive due process or jurisdictional attack on the foreign adjudicative proceedings, the Commission may be required to permit relitigation of the underlying offense. 29/

b. Felonies as bases for statutory disqualification

In addition, the legislation would amend newly redesignated subparagraph (F) of Section 3(a)(39) of the Exchange Act, which by cross reference to Section 15(b)(4) of that Act makes persons convicted of specified felonies and misdemeanors subject to

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29/ Similarly, in a Commission review, pursuant to 15 U.S.C. 19(d)-(f), of an SRO disciplinary or membership proceeding against a person subject to a statutory disqualification, the Commission might find it necessary to remand the proceeding to the SRO for relitigation of the underlying offense in cases where persuasive due process or jurisdictional challenges to the foreign proceeding are made.

statutory disqualification, by adding "any other felony" to the crimes listed as possible bases for denial of SRO membership or participation or association with an SRO member. This provision would permit the Commission and the SROs to scrutinize persons who have been convicted of crimes that are not currently specified, such as taking of property, assault, murder, and drug trafficking. The proposed amendment responds to concerns brought to the Commission's attention by the National Association of Securities Dealers. The National Business Conduct Committee of the NASD, which is responsible for all NASD disciplinary actions, has endorsed this provision of the proposed legislation as a desirable means of improving ethics in the securities industry. Of particular concern to the NASD was the recent association of a convicted drug dealer with an NASD member firm in a principal capacity. The Commission expects that the national securities exchanges also will find it appropriate to review the qualifications of persons seeking membership or association who have been convicted of felonies.

3. The proposed legislation

Sections 3 through 6 of the proposed legislation would add new Sections 15(b)(4)(G) to the Exchange Act, 203(e)(7) to the Advisers Act, and 9(b)(4) to the Investment Company Act. These provisions would apply the proscriptions of Sections 15(b)(4)(A), (D), and (E) of the Exchange Act, Sections 203(e)(1), (4), and (5) of the Advisers Act, and Sections 9(b)(1), (2) and (3) of the Investment Company Act to an international context. Thus, the

Commission would be able to impose sanctions on the professional if the professional has been found by a "foreign financial regulatory authority" -- a defined term in the Acts -- to have made false or misleading statements in registration statements or reports filed with the authority; violated foreign statutory or regulatory provisions regarding securities or commodities transactions; or aided, abetted, or otherwise caused another person's violation of such foreign securities or commodities provisions or failed to supervise a person who has committed a violation of such provisions. The term "foreign financial regulatory authority" would be defined in new Sections 3(a)(51) of the Exchange Act, 202(a)(24) of the Advisers Act, and 2(a)(50) of the Investment Company Act. It would include a "foreign securities authority," which is defined in Section 3(a)(50) of the Exchange Act, or an organization that is essentially equivalent to a self-regulatory organization. The term "foreign securities authority" would also be defined under this legislation in Section 202(a)(23) of the Advisers Act and Section 2(a)(49) of the Investment Company Act as it is defined under Section 2(a)(50) of the Exchange Act, *i.e.*, "any foreign government or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws relating to securities." 30/

30/ As noted above (*supra* n. 18), Section 15(b)(6) of the Exchange Act and Section 203(f) of the Investment Advisers Act authorize the Commission to limit activities of a person associated or seeking to become associated with a broker-
(continued...)

Sections 15(b)(4)(G), 203(e)(7), and 9(b)(4) are substantially similar to the subsections of 15(b)(4), 203(e), and 9(b) discussed above. The most significant difference between the existing and the new provisions is that the legislation would not require that the foreign authorities find "willful" misconduct, i.e., a "willful" false filing, a "willful" statutory violation, or "willful" secondary liability. The Commission recommends this approach because of a potential disparity in standards of willfulness in different countries and because some countries may not require a "willful" violation. The proposed language would provide the Commission with flexibility in deciding whether the facts of a particular case indicate a state of mind comparable to willfulness so as to warrant imposition of sanctions.

In addition, Section 15(b)(4)(B) of the Exchange Act and Section 203(e)(2) of the Advisers Act would be amended to grant the Commission explicit authority to consider convictions by a foreign court of competent jurisdiction of any crime enumerated in current Section 15(b)(4)(B) and Section 203(e)(2) or a "substantially equivalent" foreign crime; Section 15(b)(4)(C) of

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30/(...continued) dealer or investment adviser if the Commission finds that the person has committed any of the acts or has been convicted or enjoined as designated in Section 15(b)(4) or Section 203(e). Because this legislation requires the addition of new paragraphs in Section 15(b)(4) and Section 203(e), it provides for conforming amendments to Section 15(b)(6) and Section 203(f). Section 3 of the legislation would also make conforming amendments to Sections 15B(c), 15C(c), 15C(f), and 17A(c) of the Exchange Act.

the Exchange Act and Section 203(e)(3) of the Advisers Act would be amended to state explicitly that the Commission may consider injunctions imposed by a foreign court of competent jurisdiction in connection with any of the activities designated in the statute, or a "substantially equivalent" foreign activity. The Commission would have authority to restrict association with a registered investment company based on the same factors in new Sections 9(b)(5) and (6).

It should be noted that the Commission does not recommend an amendment to Section 9(a) of the Investment Company Act, which prohibits association in certain capacities with a registered investment company by persons who have been convicted of certain offenses or who have been subject to specified injunctions. Section 9(a) is a self-policing mechanism, the purpose of which "is to prevent persons with unsavory records from occupying these positions where they have so much power and where faithfulness to the fiduciary obligations is so important." 31/ The automatic disqualification provisions of Section 9(a), coupled with the Commission's exemptive authority under Section 9(c) to avoid any inequitable results, are indispensable means of safeguarding the integrity of registered investment companies. However, due process concerns may be presented by legislation that would automatically bar a person solely on the basis of a foreign finding of a violation of foreign law, without any prior notice

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31/ Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 46 (1940).

or opportunity for hearing by a U.S. court or administrative agency. These concerns are avoided if the Commission determines, on a case-by-case basis, whether the foreign finding justifies a bar, rather than relying exclusively on a foreign finding of a violation of foreign law. The amendment would not create any competitive disparities because, just as Section 9(a) applies equally to U.S. and foreign persons that have been convicted or enjoined in a manner specified in the statute, amended Section 9(b) would grant the Commission authority to institute an administrative proceeding against either a U.S. or foreign person that has committed an equivalent foreign violation and has been sanctioned by a foreign authority.

D. Reimbursement of expenses incurred by the Commission in assisting foreign securities authorities

Federal appropriations law prohibits federal agencies from accepting funds from outside sources absent specific statutory authority. Accordingly, Section 7 of the bill would amend Section 4(c) of the Exchange Act to permit the Commission to accept reimbursement from a foreign securities authority or on behalf of such authority, for travel, court reporters, subsistence, and other expenses incurred by the Commission, its members, and employees in carrying out investigations for the foreign authority pursuant to Section 21(a)(2) of the Exchange Act or in providing other assistance. Foreign authorities have, in certain cases, agreed to reimburse the Commission for such expenses. Indeed, the Commission has already incurred significant travel expenses in providing assistance to foreign securities authorities. In recommending this amendment, the Commission expects to seek reimbursement only for its out-of-pocket expenses incurred in providing assistance to foreign securities authorities.

III. CONCLUSION

Internationalization of the U.S. securities markets presents some of the greatest challenges to the Commission's efforts to protect the U.S. markets from fraud. The Commission believes that it has made great strides in developing mechanisms and approaches for policing the internationalized U.S. markets. The International Securities Enforcement Cooperation Act of 1989 would provide the authority necessary to build on this momentum.

Senator **Dodd**. Let me if I can begin by asking sort of a broad question and get your response to it. I'd like to get your assessment of what you see as the greatest risk, if you will, confronting the U.S. securities markets and the capital formation process in the next decade. What are those risks and what steps, in your view, should be taken now by both the private sector and by government—what steps can we be taking and what steps can the private sector take to minimize those risks as you see them?

Mr. **Ruder**. I would answer that question in two ways.

The first has to do with the safety and soundness of our own system in the United States with some corollary attention to matters abroad. The second, addresses the question of possible loss of the importance of the U.S. position in the world's capital markets.

With regard to the first, as you may know, the Commission has cooperated with the self-regulatory organizations, with the Federal Reserve Board, with the CFTC and Treasury to develop systems to improve our markets here. We have made great progress, I think, in improving the order routing and execution system, the automation of securities transactions. We have improved broker communications with customers. We are working very hard to improve the clearance and settlement system, which has been subject to a worldwide initiative proposed recently by the Group of Thirty. We have worked on information exchange between exchanges and within markets, and we have devoted some time to putting circuit breakers in place so that we can have a pause in our markets should they have problems.

There is an area that I believe needs further attention. It's a very difficult area. That is the question of how to make more capital available in times of market stress. I have urged caution by institutional investors in their investment strategies so that they do not lead us by some herd instinct into a dramatic market decline. I have also urged the institutional investors and the corporations of America to consider that they may have some responsibilities to step forward in a market crisis to provide the necessary liquidity.

In the other area, the area of protection, if you will, or motivation of our own financial services industry, I think that there is a great deal to be done in terms of providing a meaningful competitive position for us.

With regard to regulation, I think it's fair to say that the automation of our securities markets is the driving force, both nationally and internationally, and that we will see over the next years this automation producing regulatory problems for us. We are hesitant at the Commission, however, to try to introduce regulatory measures before these systems become operational because we do not want to interfere with innovative product design and systems. We are monitoring and watching carefully.

Senator **Dodd**. What sort of things do you see as being difficult? I mean, I appreciate your not wanting to step in and try to regulate automation that hasn't occurred yet, but be a little bit more specific, if you can, about that.

Mr. **Ruder**. What will happen, in my opinion, is that we will begin to have what's called screen-based trading of world class debt and equity issues, at the corporate level at least, throughout the world and that we will begin to see after-hours trading in stocks and bonds. This screen-based trading, if it is on a 24-hour basis and is systematic throughout the world, is going to present regulatory problems because the question will be who is going to regulate those markets. We are looking at that problem. We must look, as well, at the rise of what might be called proprietary trading systems. That is, systems which do not have an exchange membership as their base, and the question of how those proprietary systems should be regulated is one that is of great interest.

In the clearing and settlement area, we have urged internationally, and are cooperating in the development of, clearing and settlement systems in which each country has an automated net settlement immobilized security clearing and settlement process. We have also urged intermarket links between the clearing agencies in countries, so that we can achieve the kind of stability in the clearance, settlement and payment system which will be very important as our markets develop.

These matters are very technical and very important. It is also, I think, important to look at our disclosure system. We have the most rigorous disclosure system in the world, and one of the problems that we face is how to accommodate the interests of foreign issuers coming to our markets in the face of our more rigorous disclosure system. We need to look at the question of whether and how we should relax our disclosure system at all in order to accommodate this. In that area, we are proceeding with multilateral discussions about relaxation of disclosure, and we are also looking at accounting systems which are the very hardest area. Our Chief Accountant is participating in the IASC, the International Accounting Standards Committee, to see whether there can be some harmonization of international accounting standards.

The issues are enormously complex. Rather than looking at them all at the same time, we think that we can parcel the issues out. As I think my opening statement setting forth the different areas indicates, we can look at them in individual areas and try to attack each problem individually and eventually look towards a very well-coordinated global system.

Senator Dodd. Let me jump in other area quickly. I see the yellow light, but with just the two of us here, we can probably dispense with that clock there. [Laughter.]

Yesterday, in chatting with Chairman Greenspan, one of the statements that he made, that again I think was generally supported by all of our witnesses, was the notion that certainly one of the things that became quite clear after the October 1987 break, as we now euphemistically call it, was that our securities options and futures markets were really one market. What I want is you to comment on that conclusion that others have reached to see if you agree with that. We also have seen the difficulty of getting the different regulators of those markets and the participants of those markets to agree on a given set of practices. Now clearly some very constructive steps have been taken since October, 1987. But we know that we still have some significant disagreement in a number of areas. The margin area is one, which, as I mentioned yesterday, I spent Monday in Chicago, and the Chicago Board of Options Exchange really spent a whole lunch on that one issue, which won't come as a great surprise to you.

That remains an area of disagreement. Differences between the SEC and the CFTC with respect to coordinated clearance in the domestic markets is another area where agreement has been slow.

It gets to this particular point. One, do you believe that the one market theory applies to global markets? Are our domestic and foreign financial and securities market so interdependent that from a regulatory standpoint we must look at them as one, in your view?

Secondly, if we have difficulties in forging compromise and agreement among regulators of our domestic markets, what do you see as the outlook of greater cooperation and coordination on global markets on the international front? Can you identify, as well, the significant areas where you believe that international coordination is likely and where it is less likely.

Lastly, again we discussed this with Chairman Greenspan yesterday, comment on whether or not in your view there is enough effort being made. The Group of 30 is pursuing the clearance and settlement issue. There is a lot of discussion going on among regulators. I know you have talked to your counterparts, but is there enough of a coordinated effort going on, in your view, to really minimize the kinds of problems we have seen or to maximize the greater coordination that I think we all recognize must exist within the next decade if these markets are to be successful?

That is a lot of "one" question, but . . .

Mr. RUDER. I will try to respond as briefly as I can. Nationally, I believe that there is a single market involving stocks, options on stocks, and the futures products on stock indices. The question of how that should be regulated is one that has been the subject of debate and is not one which is being pursued actively by me or the Commission, in terms of legislative change. I believe, however, that it is possible for good cooperation to exist between the regulatory authorities, and I can report to you that the degree of cooperation between the Commission and the CFTC in this area is quite good. We are regularly in contact with the CFTC, and I believe that we can act cooperatively.

With regard to the margin area, I have some personal disagreements, as you know, with the way in which the margin system works. Again, we haven't pursued this on a Commission basis very vigorously. My own view still remains that we ought to have coordinated margin regulations in accordance with a somewhat more rationalized system than we now have. I think the important thing, however, internationally, is to recognize that the United States and Japan are the only nations in which the regulation of the various financial markets is split the way it is in the United States. We have three regulators, essentially. We have more than one banking regulator, and we also have separate banking, securities and futures regulators.

Worldwide, it is the banking regulators that regulate all of these areas, so that the idea of uncoordinated regulation is not likely to be one which exists in other countries, since there will be a single banking regulator which can make ultimate decisions regarding this regulation.

We must face internationally the problem of dealing with regulatory bodies which may be somewhat different from ours. For instance, when I found myself in what we call our quadrilateral talks with the Fed, the Bank of England and SIB over in Great Britain, we were dealing with what is a recognized difference in regulation, that there is a different manner of regulation overseas.

Nevertheless, I can report to you that, in the securities area, more countries are beginning to recognize the necessity of having a separate securities regulatory commission. Such a commission, as you know, now exists in Great Britain where previously in did not. Japan has had one for a long time, but more recently, we have seen legislation and the growth of organizations like the SEC in the Netherlands, in Spain, and I understand, in Finland, there is legislation that is going this way. I think there is a growing understanding that there are differences between the regulatory needs in the securities business and those in the banking business. Here I think it is important to recognize that we are dealing in the securities business with high risk activities, short-term risk activities, which require a different kind of regulation, I think, than the banking system really has.

The existence of the International Organization of Securities Commissions is a very important step forward. That organization until three years ago was more or less just an annual meeting organization, but three years ago in Paris, Chairman Shad made a speech in which he urged the organization of working groups, and since that time we have had active working groups dealing with specific subject matters—capital adequacy, disclosure, enforcement and accounting matters. These groups are working actively and involved in face-to-face discussions, so that we are moving towards, I think, international understanding of where we should be going.

I am pleased to say that there is a dramatic increase in cooperative attitudes between securities regulators worldwide. I cannot tell you that all the problems are being solved, but we are certainly giant steps forward from where we were three years ago, and I suspect that the increase in cooperation will be geometric, as we move into the future.

Senator DODD. That is encouraging. A good part of yesterday's debate focused—from the private sector, particularly—on Glass-Steagall. Not surprisingly, those who came from the commercial banking sector advocated very strongly for, if not the repeal of Glass-Steagall, as close to repeal as you could possible get. Others, from the securities industry, indicated that they didn't think that that was really the problem, that regulatory reform was really not so much the problem as was our lack of savings in the U.S., which I have already indicated. Several witnesses said that if they had to identify any one thing, that would be the one area in which they would encourage the government to move aggressively.

I wonder if you might just comment quickly, if you could, on Glass-Steagall, on the issue of savings, and which of these issues really has a profound effect on the loss of the competitiveness of our capitol markets.

Mr. RUDER. Well, as you know, the Commission position is that we support reform or repeal of Glass-Steagall as long as there is provision made for the Commission to regulate the securities activities of banks. I think that repeal or reform is essential for us to consolidate our competitive position internationally. We are under some severe constraints because our banks and securities people can't do the same things abroad that others can. I think those restraints need to be removed, and I do think that the capital strength of the resulting institutions will be better. I am not an economist and can't really discuss adequately the savings question. I do understand that the economists generally are in agreement that we should increase the savings rate in the United States as a means of financing our deficit and as a means of bringing our economy to better order. But I can only say that that is a third party statement as far as I am concerned.

Senator DODD. I appreciate that. I have taken far too much time. Senator Heinz.

Senator HEINZ. Chairman Ruder, I think you properly identified the two greatest problems or risks to the system when you talk about making sure that our markets are both stable and liquid in the face of stress and, secondly, that we maintain the competitiveness of U.S. financial markets.

As you know better than anybody else, the main thrust of the 1933 and 1934 Securities Acts were, above all, investor protection, and that is what our registration provisions are about. That is what the creation of the self-regulatory organizations in the 1934 Act are all about; the exchange standards and so forth. As a result of that, U.S. equity markets are, as a general matter, much more stringently regulated than are other major equity markets abroad. The obvious question arises as to how that globalization process that was discussed yesterday, is going to affect the future framework of stock market regulation in the U.S., and to what extent, in order to meet the competition from foreign markets, will we have to liberalize or modify our standards.

You have mentioned some initiatives that the SEC is undertaking that I would generally characterize as liberalism. But my question to you is, what does this really portend for shareholder protection? Are we necessarily on a slippery slope away from the basic underpinnings of the 1933 and 1934 Acts, away from the high standard of investor protection that we have traditionally observed?

Mr. RUDER. No, I do not believe we are. The adjustments in our disclosure mechanisms, I think, will always be made with an eye to making sure that there is adequate disclosure of information to the markets. We are fiddling with the system and not trying to trash it.

I think the other part of it, which I did not emphasize in my response to Senator Dodd, is that we will continue a vigorous enforcement system for shareholder protection, and our antifraud regulation will continue to be as strong and even stronger than it has been in the past. There has been a great deal of debate about whether a strict enforcement system is going to enhance a securities market, and it is at least my opinion that capital will flow to the market which is recognized as a market with a high degree of integrity. For that reason, I think that the enforcement efforts are consistent with the maintenance of a strong capital market here.

Senator HEINZ. You mentioned your more recent rulemaking initiatives, Rule 144, Regulation S, and reciprocal prospectuses. I am inclined to agree with the general intent of those proposals, which is to innovate in the face of change. If you don't innovate in the face of change, you will be left high and dry and gasping on the beach. But some would suggest that you are going too far in trying to accommodate foreign issuers. In particular, they would argue that Rule 144 is a large step backward from the disclosure orientation of the 1933 and 1934 Acts.

Is the process really necessary to maintain competitive markets? Where do you draw the line on the appropriate level of disclosure?

Mr. **Ruder**.We are going to repropose Rule 144(A) in response to a number of comments that have been received, or at least I understand the staff's recommendation to us will be to repropose it. There has been substantial concern that Rule 144(A) went too far in terms of creating a private market for securities. There is a suggestion that we should draw back to having 144(A) merely recognize the institutional private market which exists, and to try to structure around that market. I can't predict either what the staff will say or what our Commissioners will do.

Senator **Heinz**. Let me ask you a personal, but not necessarily philosophical, question, which is: in general, do you think we should revise the 1933 and 1934 Acts to allow institutional investors, who are supposedly sophisticated, knowledgeable, expert and all the other qualities that they claim, to fend for themselves?

Mr. **Ruder**. I don't believe we need to revise the Act in order to accomplish that goal.

Senator **Heinz**. Let me rephrase my question. As a general matter, whether or not we revise the Acts per se, philosophically, is it your view that institutional investors who are all those things I said, or they at least say, should be allowed to fend for themselves? They don't need your help?

Mr. **Ruder**. Yes. I agree with that.

Senator **Heinz**. But for the institutional investor, it is caveat emptor.

Mr. **Ruder**. The idea is that they are smart enough to know what to ask, and they have sufficient financial power to force the answers to those questions. Of course, they would still be protected by other provisions of the federal securities laws, such as the antifraud provisions, regardless of whether or not the transaction was exempt from the Securities Act registration requirements under Rule 144(A).

Senator **Heinz**. I would love to know who the institution was that advised Time shareholders that the Warner deal was a good deal.

Mr. **Ruder**. I don't know the answer to that question, and I doubt my enforcement staff would let me comment on that.

Senator **Heinz**. That was a gratuitous comment, and so it should probably be stricken from the record. But presumably, somebody hired a very sophisticated investment banking firm that according to the market only got it wrong by $60 or so a share. Such is life, I guess.

Senator **Dodd**. They were doing it the old way.

Senator **Heinz**. Yes. Yes. You will listen to some other things I shouldn't say too. [Laughter.]

Thank you, Mr. Chairman.

Let me get at this issue which is a significant issue, I think, in another way too, because virtually every witness who has come before this committee, and I don't mean just yesterday, but on lots of other occasions, has identified institutionalization as one of the principal contributing factors to the globalization process. Given that, and given the advances in telecommunications, screen based trading, 24-hour trading, more products, different products, different trading strategies, what does the future hold for the individual investor that we all say we want to protect? Is he or she going to be there, or are they so out of it with all these new products, instruments, and technologies, that they are relegated to using professional investment managers through mutual funds or otherwise? If that is true, what does that mean for us?

Mr. RUDER. I will give a "the glass is half full or half empty" answer. Forty-five percent of the equities in this country are owned by institutional investors. Fifty-five percent are owned by individuals.

Senator HEINZ. That's overall.

Mr. RUDER. That's overall, yes. The 45 percent is a very significant figure, and 70 to 80 percent of the transactions on the organized exchanges is due to these institutions. I think, however, that the individual investor still has a very fine opportunity to buy stocks that have value and hold those stocks and get rich.

Senator HEINZ. And sell those that aren't going to have value.

Mr. RUDER. By and large you find people who suddenly wake up one morning and find the stocks that they have held for 30 years and haven't paid much attention to are now worth millions. That really, I think, indicates the kind of reward for patient investment that one ought to look for.

Senator HEINZ. It is also a prescription for continued vigilance and prudent regulation by the SEC, is it not?

Mr. RUDER. Yes, it is, but I have a personal view that many, many of our private investors are misguided in terms of what the stock market is all about. They think in terms of winners and losers and short-term profits and ability to make timing decisions. None of that is appropriate, in my view, for the small investor. When I think of small investor, I think of the patient, long-term investor as providing a real cornerstone for our economy.

Senator HEINZ. As opposed to arbitrage and all of the rest?

Mr. RUDER. All of the rest.

Senator HEINZ. An interesting regulatory dichotomy is, of course, that in the international securities markets, securities transactions are, to varying degrees, heavily regulated. It depends on what country you are talking about. Certainly, here it is true. Yet currency exchange and swap markets aren't. There don't seem to be any major problems, at least as yet, in the latter markets.

Does that mean we are overregulating the securities market?

Mr. RUDER. No, I don't think so. These currency and swap markets abroad and even in the United States, when we talk about our primary dealer market in Treasuries, are very, very liquid markets, and they have an enormous number of participants. There seems to be some self-regulation going on in terms of the participants being so sophisticated that they are able to trust each other, and they have transaction, payment and settlement systems which work.

In the securities markets, we don't have that phenomenon as much, and, as I look at it, we have far more products. We have in the United States, I believe, 14,000 companies which are registered with us as public companies, and there are markets for the securities of all 14,000 of those companies. That involves a much different system than you could talk about if you are talking about a system with basically fungible financial products such as Treasury bills or Eurodollars or interest rate futures.

Senator HEINZ. Yesterday, I gather that there was a fair amount of discussion about international clearance and settlement. You touched upon that in your remarks, and in that connection, you indicated that the Commission plans to assist in efforts to evaluate and implement the Group of Thirty recommendations.

Mr. RUDER. That's right.

Senator HEINZ. Could you be a bit more explicit in identifying some of the specific steps you are taking in that regard, or planning to take, to improve clearance and settlement mechanisms and implement the relevant recommendations of the Group of Thirty?

Mr. RUDER. The Group of thirty report had some nine separate——

Senator DODD. Let me raise one question. Why is that important, the clearance and settlement question?

Mr. RUDER. It is probably the least well-known but most important facet of our securities markets. When I try to talk about this subject to lay groups, I say, you may not think clearance, settlement and payment systems are very important, but the real question for you, as an investor, is, will you get paid? When you start to put it into those terms, if you have a system in which the contraparties, parties on each side of the transaction, don't know whether they are going to get paid or not, you won't have an effective system.

Senator HEINZ. I think the chairman wants this on the record so everybody is clear on how critical this is. There are different settlement dates all around the world. In New York, it is five days. In Germany, it is three days

In Italy, I—it's manana, you know. There's no word that conveys the urgency of manana in Italy. [Laughter.]

Senator DODD. In Japan, it's yesterday. [Laughter.]

Senator HEINZ. And obviously, if we have a truly linked market, we could get to the point where we have one just truly linked group of exchanges, everybody with a computer terminal, trading on a screen, between, for example, Milan and New York and Tokyo, 24 hours a day—people never seeing their wives and children, and all the other terrible things that could happen. You've got the discontinuity of people not settling up in Milan until the next month. There are obviously serious problems that could develop.

Is that too apocryphal a view?

Mr. RUDER. No.

Senator DODD. And do you support my child-care bill, as a result, Senator Heinz is saying? [Laughter.]

Mr. RUDER. Your vision of a single global trading system all done on the same international exchange, no matter how defined, with a single international clearance and settlement system, is one which is, I think, many, many, many years away rather than a few years away.

Senator **Heinz**. Apart from that, as they say?

Mr. **Ruder**. It is extremely important, if we are going to develop systems that we have the ability to have transactions take place between residents of different countries. The way the Group of Thirty report proceeds, is based, in part, upon a recommendation which the Commission made in the early stages of its report. Instead of trying to have a single global clearance and settlement system, we have separate clearance and settlement systems in each country. I may say, even in the United States, it is important that we have these systems. In the October 1987 market break, we had near breakdowns in some of our clearance settlement payment systems, breakdowns which would have been just as severe for the economy as the degree in drop in the market.

One of the reasons that the working group on securities markets has prospered has been its joint recognition of the clearance and settlement function. If you take the nine recommendations of the Group of Thrity, six of them are already fairly much in place in the United States, so that we are moving to questions of how and whether to implement three of them.

The first one is an increase in the trade comparison feature. We are working actively with the exchanges to move the day in which trades are compared in the stock markets to what is called T plus 1, the day after the transaction. Heretofore, that has been T plus 3, and we want to move it forward so that the parties within the market will know to whom they owe money. That T plus 1 comparison system is something which we are moving toward, and which we think is a feasible result.

The Group of Thirty then says that we ought to have settlement on T plus 3, three days after the trading date. Today in the United States, our settlement system in the stock market is T plus 5, and we are not yet moving rapidly towards T plus 3, and there are some objections to it, objections that need to be dealt with and dealt with carefully. The question for institutional and professional investors is not a difficult one because the institutional investors and the brokerage firms doing proprietary trading are participants in a certificate-less security system, and they can make settlements if they know who they owe within a three-day period.

The problem here is for the people who have certificates to find their certificates and send them to the broker and to have the broker be able to count on their doing so so that it can clear in three days. So the three-day settlement has some very great difficulties in it.

The third question of great importance is the transfer from so-called next day funds to same day funds, and the question there is, will we change from a system which we have in the United States that when you pay at the end of the day, you pay by check, which doesn't clear till the next morning, or do you pay in some way in funds which are available to the other side on the same day. That change, if it were to occur, would have very great impact on the way our systems operate, and we believe will require even greater attention.

Here I may say, speaking individually, that I think it is necessary that the United States not be the country that opposes what is clearly a rationally good system. We find ourselves now being on the outside of a system in which, because of the Group of Thirty Report, Germany and Japan and England and all the other countries now have a system which works better than ours. I really believe that there is a lot of self-interest in making our own system the best that one could imagine.

Senator **Heinz**. Chairman Ruder, that is a very good and comprehensive answer, and I thank you for it. I have one last question which came to mind when I was visiting the Tokyo Stock Exchange last April? There, of course, they do have a trading floor, but if you don't want to do business on the floor, you can move upstairs and do all your trading on a screen, and the floor is there, in a sense, just because they want to show you something. [Laughter.]

You ask them, why do you need that? And they say, well, we could do it all up on a screen, but we don't have the specialist system, we don't have somebody that is a market maker who provides liquidity. The question I asked myself was well, if the Tokyo Exchange does not need a specialist system, who does? I suspect it's us. Somewhere along the line we assume most of the risks for Japan.

The question I've got is, what is going to happen to the specialist and the system that we all think of when we think of the floor of the New York Stock Exchange and most of our other exchanges? What is going to happen as the markets become more interrelated and interdependent? Is what we see today in New York going to go the way of the dinosaur, or is it going to evolve and turn into some 5,000-pound gorilla?

Mr. **Ruder**. I really can't answer that question. We have two interactive places where securities are traded. One is in the pits and the futures exchanges and on the floors of our stock exchanges. It is possible to have screen-based trading, and, as you know, in Japan, they have two systems. In their second tier, they have a purely screen-based automated trading system, and they don't have anybody trading in the stock. In their most active stocks, they do have a floor, but some tell me that the floor isn't essential to their trading system. I don't know the answer to that, but one has to ask the question of how it is that human beings will desire to communicate, and I don't think that that answer is yet apparent.

If you have ever gone down to the floor of the stock exchange in busy times or into the commodities or option pits, you will see that the communication is really fast, and the question is whether or not people are going to be willing to step away from that. I guess if you asked me to make my long-term bet, I would say probably eventually, yes.

Senator **Heinz**. If that is right, should we allow the process to develop slowly, in a sense be sure it goes very slowly, or should we take steps to facilitate the evolution in a more timely fashion?

Mr. **Ruder**. There is no doubt about the fact we should take steps to allow something to happen. We should not be in the way of it happening, but I think that if you have an economic system that is working as well as our country's does and a capital market that works as well as ours, you may want to hesitate before you step in and say we think you fellows ought to disband it and start another kind, because you may not end up with something that is as good as you already have. I think natural market forces will result in change over time, and certainly, the regulatory system ought not to step in the way.

Senator **Heinz**. One thing that, in a sense, troubles me about that scenario is that the market making and liquidity function that we tend to place a fairly significant value on will obviously disappear, and the question is, how significant is that?

Mr. **Ruder**. You know the leader in non-exchange market making, nonfloor market making is our very own National Association of Securities Dealers. It has been their automated system for trading using competing market makers, using a screen-based system which, indeed, has been a model for the International Stock Exchange. I think it has made it possible for the futures exchanges to imagine Globex and Aurora and their complicated systems.

Senator **Heinz**. Mr. Chairman, I understand that. The question is——

Mr. **Ruder**. They do have good depth and liquidity in that NASDAQ system for the more high volume stocks, so one can't predict whether or not, if you moved away from the floor, whether you would have sound market-making liquidity. I happen to think, yes, if there is a natural market reason for people to want to trade stocks, if you don't have a floor, they are going to do it off the floor and do it in an automated way.

The question is whether or not there is a great deal to be gained by having those people talk to each other every day and have a feel for what is going on. I guess we are all human, and I somehow get a little frightened if I think everybody is going to be able to do everything in their own house and never have to get outside to buy stocks and groceries.

Senator **Heinz**. It makes that 24-hour-a-day a lot easier.

Mr. **Ruder**. Yes. There is an opinion that says that, in the securities area, 24-hour trading will always be dominated by the local marketplace. That is, the market for American stocks will be dominated by the American trading and for Japanese stocks, by the Japanese, and for European stocks, by the Europeans, and that the other trading will be peripheral to those main markets.

Senator **Heinz**. Mr. Chairman, thank you.

Senator **Dodd**. Thank you. Let me just come into that last question that Senator Heinz has raised. It is a very important one. I again had a chance to see Globex, at least a model, in Chicago early this week. And the question that I raised with the people at the Board of Trade is exactly the question Senator Heinz has raised. Who makes the market? I mean, there are the locals, so to speak, in the pits today that make that market, and there is a great concern as to how world-wide trading is going to operate and work in the absence of that human element. With screen-based trading, you sort of take that element out, not to mention the liquidity issue.

Mr. **Ruder**. In the screen-based trading, company A says, we are a market maker in this area, and here is our quote. Someone else says, all right, we will hit your quote. The question then is, for how many shares or what quantity will this person be willing to make a firm market, and then you do get into some real questions about liquidity. As I understand the theory of Globex trading or NAS-

DAQ's recent announcement about some possibility of after-hours trading in its market, there will be market makers who will be willing to trade in size using a screen and the liquidity will be there.

Now I share your concern that it might not be. You certainly wouldn't want to say dismantle the floor and let's go to some other system. Again, however, I see no reason why it shouldn't be there, if one were to create a different market.

Senator Dodd. What about the third element that Senator Heinz has raised and that is crime. I remember when I was in the House, when Mill Batten was chairman of the New York Stock Exchange, and I went to see him and asked him what his problems were. He said, well, one of the issues was this whole question of off-floor trading, and one of the great concerns then was that this would be more difficult for your enforcement officers to apprehend the fraudulent operators.

Mr. Ruder. I think today it is quite the opposite. Screen-based trading has the advantage of creating a trail. The computers don't forget to write it down, because it is part of the system. You can go back and create an audit trail. That is going on right now in the NASDAQ system where they are proposing to bring more of their penny stocks into the system and having a better audit trail for it.

I don't think that there is anything inherently bad about those systems in terms of enforcement. I would much prefer to see the early development of these 24-hour trading systems or screen trading systems to be done in a system where a single regulator had jurisdiction. That is, for instance, what is going on in the Globex. It will be the Chicago Mercantile Exchange product which is traded 24 hours, and anybody that desires to trade in that system is going to have to say I accept the regulation of the CFTC over that product and the Chicago Merc regulation, and the clearance and settlement will be done all in the United States. That same kind of a system would give a lot more regulatory certainty, if I could know that all of the after-hours trading in NASDAQ stocks would be in a NASDAQ that we would regulate, or in London stocks would be in a system regulated by the British. What would give rise to some regulatory concern would be if you tried to have a cooperative agreement in order to pass the regulation along with the book, if you will.

Senator Dodd. I didn't mean to dwell on that.

Mr. Ruder. They are really hard questions which need a lot of analysis.

Senator Dodd. Let me jump to one or two other points very quickly. We have kept you a long time as it is. Yesterday, Robert Hormats, in testifying before the committee, noted that the problem, and I quote him here, he says, "The SEC does not have regulatory authority over unregistered foreign subsidiaries of U.S. securities houses, and offshore activities of foreign subsidies of all countries are regulated only with difficulty."

I know this is an issue we have addressed in legislation that was the subject of a hearing last month, S. 648, in the provisions dealing with risk assessment for holding company systems. You were not at that hearing, and it would be helpful if you could give an example or two about why you need that authority, particularly in the global market. You could follow that one up with the giving us your opinion on whether or not foreign securities regulators have similar authority, or if we adopt this provision, will we be placing on our firms a competitive disadvantage?

Mr. **Ruder**. I believe that the U.S. securities firms are the only competitors in the major securities markets in the world which are not subject to the kind of regulatory oversight that we seek in our risk assessment legislation. I think if our risk assessment legislation should be adopted, it would improve the competitive system for our markets. If there is a holding company which has a broker-dealer affiliate in it, a parent with a broker-dealer which is engaged in business, there will be sister affiliates which will be engaged in other kinds of activities, and these holding companies will take much of their really risk-based activities out of their broker-dealer system because of difficulties with our net capital requirements and regulatory matters, and they will engage in such things as bridge loan transactions in connection with takeovers, foreign currency transactions, and interest rate swap transactions, all kinds of transactions which have a great deal of risk in them. And yet, as the U.S. regulator of these broker-dealers, the Commission doesn't have access to the information regarding what their risk positions are.

And what difference does that make? In times of stress when there is a call to us to say we hear that such-and-such a company is in trouble, we don't know whether that company is in trouble or not. Because the problem may be not that the broker-dealer is in trouble but that some other element of the holding company system is in trouble. It is not only whether they actually are in trouble but also what the bankers call contagion. If unit A is doing fine, but unit B is reputed not to be doing well, then people may not want to deal with unit A, because it is part of the same system.

We would like to be in the position of knowing what their risks are, so that we could confer with other regulators such as the Federal Reserve Board or the CFTC to see whether there is something we should do. There was some comment about the possibility of the Fed having power to get this information. We do know that in some sense the Fed has more power to get information from our broker-dealers than we do, because many of those broker-dealers are primary dealers in the bond market which the Fed regulates.

But that is not a rational way for the system to work—for me to have to call up Jerry Corrigan and say, Hey, Jerry, do you have any information on Merrill Lynch? That is not just the way it should work. I ought to be able to call the head of Merrill Lynch and say, we are hearing some rumors, and we would like to know what the answers to those are, and not have them be able to say, well, we don't have to answer you.

I think they should be required to answer us.

Senator **Dodd**. All right. I understand that side of the equation. The other side is, of course, the argument made that in these foreign markets that requirement is not present.

Mr. **Ruder**. It is, though. The British banking authorities are the ones that have really been pushing us. They say we don't know what to do. We are regulating a U.S. affiliate of an American holding company, and we don't have any way of knowing about the strength of the holding company. We know that about any British participant in our markets, because we can get to them through the banking regulators. In Germany, the system is constructed so the banks have all the information, I think, and share it if they need to, and in Japan, the Ministry of Finance gets it through its very intimate relationship with the banks and the brokerages.

Senator Dodd. So the argument that somehow this is only required among U.S. firms is totally without any merit.

Mr. Ruder. It is without merit. In fact, as I say, if we could have that kind of information, then we would be able to provide assurances informally that people aren't in trouble, and the rumors that so-and-so is in trouble could be dispelled.

Senator Dodd. I think we have created a pretty good legislative history here for that approach.

Let me turn now to the Fortress Europe issue. We are going to hear from one of our colleagues from the other side of the Atlantic shortly, but I wanted to discuss this a little bit with you. There is concern that we will be faced with a closed market as a result of the Europe 1992 initiative.

I wonder if you might comment on that and whether or not you are currently in negotiations with the European Community, representatives of the European Community, to address those concerns.

Mr. Ruder. Well, as you know, there has been great concern by the administration that the European Community may insist upon what is called reciprocal treatment, which would mean that no entity could enter a market unless its country of domicile allows foreign entities to operate on equivalent terms. I believe the better regulatory system, as I understand it, and I would support it, is the home country system, whereby you would treat everybody within your home country equally and then anybody that could comply with the standards that any country had would be able to enter the system. I think that is much better for competition.

In the European Community, they have recently promulgated, I think it is called the Second Banking Directive, which has given us more hope for so-called "national" or "home country" treatment rather than strict reciprocity treatment. I think that, after a lot of discussion with the Europeans that the 1992 system will move towards that kind of regulatory approach, so that Fortress Europe won't keep our people out.

Another thing that is happening is that in order to guard against the possibility that they will say everybody that is in this system can stay in it but we will have no new entrants, a lot of our financial service people are going to Europe now and establishing operations in Europe so they will have a subsidiary or an affiliate there.

Senator Dodd. I am very familiar with that.

Let me turn to another area. Senator Heinz raised the issue of a number of specific regulatory changes, 144(a) being the one that has generated a tremendous amount of interest. Clearly, the institutional investors have different needs and different responsibilities from individual investors. We watched the Japanese markets in the market break of 1987, and we didn't find a lot of the major institutional selling. There was some jawboning that went on there within the Ministry of Finance, we understand. Do you think this is the better way to be going here, that when you are looking at those kinds of situations, a crisis environment, that jawboning can work, and that you don't need to necessarily have a tight regulatory scheme in place?

Mr. **Ruder**. In the 1933 Act environment—the disclosures accompanying sales of securities—we think that the institutions are able to take care of themselves. As long as the institutions buy and sell with each other, there is not much need to impose regulation. We would not let them sell to the public, and we would continue to impose that kind of regulation.

When we move over into the 1934 Act or market area, I think that a good combination of regulation, jawboning and self-interest is the way to go. We, for instance, are looking very carefully at the net capital standards for specialists and whether or not they should be improved. We have urged the New York Stock Exchange to file, and they just have filed with us, a proposal for market basket trading of portfolios of securities on their market as a means of increasing liquidity.

Ultimately, the source of liquidity in a volatile market has to be in the private sector, and there have to be a lot of individual decisions which create that liquidity. And I suppose ultimately, as banking regulators all over the world know, the central bank has to make some decision about whether to make liquid funds available for people who want to engage in those transactions.

Senator **Dodd**. One last question from Senator Riegle I would raise with you that he asked me to raise.

It is not really an international sector area, but he would like to get your response to it, if you could.

Do you still support closing the 13(b) ten-day window period in the tender offer area? In the past, this has been a noncontroversial issue at the SEC, and Senator Riegle asked whether or not this is still the case.

Mr. **Ruder**. I asked Linda Quinn, our Director of the Division of Corporation Finance, whether our recommendation was still for five days and a standstill, and she said it is. That means our position is that we think that the filing period should be reduced to five days, but that there be a standstill imposed until there was disclosure of more than 5 percent.

Senator **Dodd**. OK. If there is any further questions, Senator Riegle can go into that with you.

Senator **Heinz**. Mr. Chairman, just on that point, if I might.

Senator **Dodd**. Fine.

Senator **Heinz**. Yesterday, the committee was advised that the EC is developing EC-wide securities regulations. Is the SEC well plugged into that?

Mr. **Ruder**. We are in active consultation with the people at the EC, and we have various people consulting. It is not quite as certain as you may have been advised, but when I talk about the Second Banking Directive, we are following and we have people who are in contact with the EC. We tend to deal in specifics. We tend to deal in the enforcement area, in the capital adequacy area, in the disclosure area, and we get bits and pieces of the larger picture. But the answer to your question is yes, we are.

Senator Heinz. Are you saying that the master plan that the Commission is working with has not yet been revealed to you?

Mr. Ruder. The EC?

Senator Heinz. Yes.

Mr. Ruder. Well, as it is revealed publicly, it is revealed.

Senator Heinz. To what extent is that, from your point of view? To what extent do you have all the information you need?

Mr. Ruder. I will have to consult with my people, but I don't think that they have declared a master plan in securities regulation at this point.

I am told that they have an investment directive. They are suggesting looking at mutual recognition of prospectuses. They are investigating in other areas, capital adequacy. There is no master plan being put forward by the EC at this point, and I think that may come, but I don't think it exists at this particular time.

Senator Heinz. OK. Thank you. Thank you, Mr. Chairman.

Senator Dodd. Well, Mr. Chairman, we thank you very much. We have kept you a little longer than I had planned to this morning, but we have covered a lot of ground.

There may be some additional questions by others. We have had busy schedules here for many members in the last two days. So there may be some written questions following up on this subject matter. But your comments are very, very helpful.

Once again, we wish you well. We hope to see you often here, as we said at the outset.

Mr. Ruder. I heard Senator Riegle's comment, and I believe it is very important that the Commission have strong leadership and make a good transition. So I am going to be quite careful with my own plans to see that I might accomplish that.

Senator Dodd. I appreciate that. We all do as well.

So thank you very much for being with us.

Our second panel and they have been very patient—I hope it's been helpful for them to hear the Chairman of the Securities and Exchange Commission—Stephen Axilrod is the Vice Chairman of the Nikko Securities Company International, Incorporated, New York; The Right Honorable Lord Camoys is a colleague of ours, a member of the House of Lords, something that the Senate is referred to quite frequently by those who disagree with some of our actions from time to time. Lord Camoys, we are very pleased to have you with us. He is also Deputy Chairman of Barclays De Zoete Wedd Holdings Limited, Barclays Bank, London, England. John M. Hennessy is our third panelist, is the Vice Chairman and Chief Executive Officer-Designate of CS First Boston, Inc., in New York.

We want to thank all three of you for joining us here this morning and I apologize for going a little longer with the Chairman of the Securities and Exchange Commission, but we hope that may have been of some interest to all of you.

You're very gracious to be with us. Lord Camoys, we are particularly grateful to you for coming such a long distance to be with us here this morning and we recognize that you normally are sitting where we are, asking questions, rather than being on the other side of the table. We are doubly appreciative of your willingness to be a witness before this committee.

In fact, one idea that I haven't really even raised with my colleague but I'll do so here, I thought it might be interesting at some point for us to talk about some joint hearings between this subcommittee or committee and some of our counterpart committees in the European Community about some of these questions. It's something we might want to explore. I just raise it with you this morning. It occurred to me yesterday when I was anticipating your appearance here today. It might not be a bad idea for us to try to get together and listen to what some of the institutions in Europe are saying about Europe 1992 and their concerns about what we're apt to be doing over here might be helpful. So we thank you for being with us, as well as you, Mr. Hennessy and Mr. Axilrod.

We will begin in the order that I've introduced you. All of your statements will be included in the record as prepared and we would ask you to summarize if you could.

STATEMENT OF STEPHEN H. AXILROD, VICE CHAIRMAN, NIKKO SECURITIES COMPANY INTERNATIONAL, INC., NEW YORK, NY

Mr. AXILROD. Thank you very much, Mr. Chairman.

It's a pleasure to be here and I will try to summarize the statement I submitted and apologize in advance for some repetition of things you've undoubtedly already heard about.

In any event, my focus will be on certain issues raised by the ongoing globalization of securities markets, particularly as seen through the growing interconnection between the U.S. and Japanese markets. As you know, by and large, the issues involved are by no means unique to those markets and you've discussed very many of them today and yesterday. The meshing of national markets is a truly global phenomenon. As you have emphasized, it's based in a technical sense on the wonders of high technology and instant communication, but I believe it's based much more fundamentally on a growing realization that a more integrated economic world has a better chance of raising living standards for everyone. I think that's basically what's behind the European Community financial moves, for instance.

The U.S. and Japanese securities markets have become much more closely related in recent years as the forces pushing saving out of Japan has been balanced, or facilitated even, by forces in the U.S. that have pulled funds inward. At around the beginning of this decade, Japan implemented a policy to reduce its fiscal deficit, and with private saving high there, this led to a surplus of domestic saving. At about the same time in the U.S., we moved in the other direction. Our fiscal deficit was increased, while our private saving rate dropped sharply. We required funds to meet our domestic needs from Japan as well as certain other foreign countries who were positioned to supply them.

The large deficit in the U.S. international current account and surplus in the Japanese account measure these imbalances in domestic saving processes and serve as the conduits for the international transfer of funds. These imbalances are, in my view, unsustainable and they are in the process of correction as, among other things, budget deficits are reduced here and private saving I hope is increased, while domestic spending rises in Japan. But the process is certainly not yet complete, far from it.

As this process continues, it draws U.S. and Japanese financial markets closer together through long-term capital outflows from Japan, which reached about $150 billion last year after being close to nothing at the beginning of the decade. The establishment of Japanese securities firms in the U.S. markets comes as they attempt to help manage those flows. What also follows is the necessary opening and diversification of the Japanese market to accommodate both their domestic needs and foreign investors and institutions as the yen is internationalized.

So as I see it, we are in a transitional stage during which Japan is establishing itself as a key player in international finance. Once existing savings imbalances are corrected, market relationships will take on a much more settled character with flows between the U.S. and Japan more two-way and with the Japanese market itself, as prevailing trends continue, even more adapted to the international market structure.

The securities industry in Japan has not been, nor has it had to be the main focus of domestic deregulation there. That's been reserved to the banking industry to date largely through the removal of interest rate ceilings. The securities industry has been more or less free to operate within the constraints of the Japanese version of Glass-Steagall and subject to the regulatory overview of the Ministry of Finance.

But globalization, associated international competitive forces, and the emergence of Japan as the leading net creditor nation have had a particular impact on the Japanese securities industry, bringing it much more prominently onto the world's stage than it had been.

Diversification and opening of the Japanese market have been matched by the diversification of securities companies into foreign markets and foreign activities.

To a considerable extent, now that Japanese industry and investors are moving abroad, securities firms have internationalized to maintain and indeed protect on a global basis customer relationships that had developed over the years in Japan. Similarly, U.S. and other foreign firms are moving into Japan because of the attraction of that market and its high capital values and high volume of business.

But doing business in foreign markets also inevitably entails development of a national customer base in those markets to some degree. That's necessary to acquire sufficient business acumen in the markets, to be established as a significant enough factor in the market to make services efficient and cost-effective, and more broadly to be able to take full advantage of the possibilities of globalization.

Now despite this domestic interpenetration of markets associated with the current phase of globalization, it seems to me that it is very unlikely that foreign security firms will become a dominant force in another country's domestic market. The strength of a foreign firm is its own domestic customer base and its expertise in its own market. Much of the business of foreign firms in another country's domestic market therefore is cross-border. For a Japanese securities firm located in the U.S., this would include, for example, sales of Japanese equities to U.S. customers, sales of U.S. equities and bonds to Japanese clients, and underwriting of offerings by non-Japanese firms and Japanese firms in the Euromarkets and of course in the Japanese domestic markets.

But some of the business, as I mentioned, is purely domestic in the host market, involving transactions in this market confined to U.S. domestic customers, including subsidiaries of Japanese and other foreign firms. This would be the case for our firm, for example, in its primary dealer operation and also to a certain extent in equity and corporate finance activities.

Of course, today globalization has another aspect in addition to cross-border business and domestic interpenetration of markets. It also involves trading of one country's domestic instruments in another country's marketplace. We've had the Eurodollar market for a long time. The Euroyen market has developed in recent years. And in a sense, these are simply domestic markets displaced to foreign shores where there's more favorable regulatory and other types of treatment. U.S. Treasury securities are traded now, however, on a 24-hour basis around the world and the potential for development of cross-country products in futures markets is absolutely enormous.

The broad market policy issues raised by globalization trends revolve around the need for more international cooperation and monitoring to assure the stability, liquidity and safety of these integrated markets and also because of domestic interpenetration to see to the fair treatment of each country's market participants in foreign countries. Basically, though, I believe markets are working reasonably well. They need some but not substantial fixing from a global perspective. Equity markets have shown resilience after the crashes. Insider trading abuses are essentially a problem for domestic markets. They have not, as such, been a product of globalization.

Useful approaches to ensuring market safety and soundness in a global context would include a broad international agreement on capital standards for security firms (as we now have for banks). Japan is remodeling its capital requirements on an American/British model, and a basis may be developing for a broader international convergence. It would also be desirable for the various exchanges and self-regulatory bodies to cross-check prudential standards generally, given the internationalization of markets. The purpose, of course, is to avoid weak links around the world hospitable to unsound trading practices.

Because national interests are involved, a certain degree of intergovernmental oversight would certainly be desirable, though I believe that should be a gentle kind of oversight. Meanwhile, central banks around the world, because they are a source of unquestioned credit, have a key role to play in assuring the ultimate safety of the clearance and settlement mechanism as it has to cope with more internationalized markets.

With regard to questions about the fairness of treatment across national markets—and this has been a big question in U.S.-Japan security market relationships—these are best handled I believe through application of the principle of national treatment. This principle is embodied in U.S. law and practice toward banking and securities markets. It is also the case in Japan. And I would hope it would be clearly adopted for the European Community, though there's clearly some fuzz around the edges there.

As compared with reciprocity as a principle, national treatment is much less ambiguous in practice and easy to administer. Foreign firms simply are treated no differently from domestic ones. Problems can arise if domestic market attitudes and business practices tend to handicap foreign firms more in one country than in another in efforts to compete with domestic firms. This may then require some reciprocal prodding in practice.

In any country, a foreign securities firm will find it difficult to penetrate domestic markets because it lacks a broad set of domestic contacts and affiliations through which business might be readily generated. But given that very practical and universal constraint, national treatment generally yields the fairest results for foreign firms when markets are more impersonal and within a country's institutional structure most competitive.

Now to summarize the summary, Mr. Chairman, globalization, as it clearly brings world security markets more closely together, will require more international cooperation and monitoring of market practices and standards by governmental and private bodies. In that sense, I would note that in the United States we may not have quite adjusted to the closer relationship of internal markets and that does complicate the international coordination process in some respects. As the stock market crash demonstrated, and as is also amply demonstrated by daily trading in equity and Treasury security markets here, the futures and cash markets are just simply one market. As they become even more involved internationally and with cross-border products, a more unified oversight domestically will help in coordinating global relationships more effectively.

I cannot avoid ending with the comment that orderly stable global markets basically depend on the major nations of the world pursuing sound, cooperative monetary and fiscal policies. Without that, no amount of high quality of regulatory oversight, prudential standards, or capital requirements will guarantee market stability.

Thank you.

[The complete prepared statement of Stephen H. Axilrod follows:]

STATEMENT ON
GLOBALIZATION OF SECURITIES MARKETS

BY

STEPHEN H. AXILROD, VICE CHAIRMAN
THE NIKKO SECURITIES CO. INTERNATIONAL, INC.

Before the

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COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
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I am going to focus on certain issues raised by the ongoing globalization of securities markets, and particularly as they are reflected in the growing interconnections between the U.S. and Japanese markets. But by and large the broad policy issues that are involved -- such as the impact of varying market structures, national treatment or reciprocity in dealing with foreign institutions, the adequacy of financial and other prudential standards, the character of regulatory or supervisory guidance -- are not unique to those two markets.

The meshing of national markets is truly a global phenomenon -- based in a technical sense on the wonders of high technology and instant communication but based more fundamentally on the growing realization that a more integrated economic world has a better chance of raising standards of living all around. The steps being taken toward a more integrated European economic community -- which really contemplate a single money and capital market and the vision (may be a chimera, maybe not) of a unified currency and central bank -- are only the most dramatic manifestations of the value thought to be derived from economic and financial integration.

The U.S. and Japanese markets in the foreseeable future will no doubt remain more independent of each other than will the individual European markets if the full vision of integration there becomes reality. But U.S. and Japanese markets have obviously become much more closely connected, and the differences between them, though still great, are being moderated. The pattern and pace of development are grounded in economic developments of the past decade.

Economic Background

The increasing worldwide prominence of Japanese financial markets and institutions during the past several years stems from both the push of domestic economic policies in Japan and the pull of domestic economic policies in the U.S. Japan could not have become such a large net lender to the rest of the world if there had not been a large willing and able net borrower to absorb the funds. Similarly, the U.S. could not have become such a large net borrower from the rest of the world if there had not been another country or countries with sufficient excess domestic saving.

The push of funds out of Japan was impelled in part by the determination of the government to reduce the burden on the economy of a large fiscal deficit which dropped from 6.2 percent of GNP in 1980 to about 2.5 percent in 1988. This sharp drop in the deficit released a great deal of domestic saving for use elsewhere. While the domestic saving rate in Japan has been lower in the 1980's than in the 1970's, it remains high compared with most other countries. With less of domestic saving absorbed by a budget deficit, the surplus funds moved overseas.

The conduit, as it were, was the emergence of a very large surplus in the current account of the Japanese international balance of payments. This surplus -- which in effect reflects the excess domestic saving -- has run at unusually high levels in relation to GNP over the past several years, peaking at around 4-1/2 percent of GNP in the 1986 and then dropping off over the past two years to around 2-3/4 percent.

While Japanese domestic policies imparted an outward thrust to their domestic saving, U.S. domestic policies from the early 1980's exerted a strong inward pull on world saving. We embarked on a policy of fiscal expansion that brought the U.S. fiscal deficit from around 2-1/4 percent of GNP in 1980 to the 5 to 5-1/2 percent range in the mid-1980's, although the deficit has been subsiding considerably in recent years. The enlarged fiscal deficit would not itself necessarily have exerted quite so strong a pull on world saving as we have in fact experienced. However, the pull was intensified by an unexpectedly sharp drop in the personal saving rate in the U.S. during the past several years.

The deficiency of overall domestic saving in the U.S. relative to need is mirrored in the large deficit in the current account of the U.S. balance of payments and the consequent shift in our external position from a net lender to a net borrower. The U.S. current account deficit ran between 2-3/4 and 3-1/2 percent of our GNP during the last five years, which is unusually high for us and is essentially unsustainable, just as is the extent of the Japanese surplus.

The process of correcting these international and related domestic imbalances has been under way for some time now. With regard to financial markets, this process has involved substantial fluctuations in foreign exchange rates, featuring a return of the dollar to levels that make the U.S. more internationally competitive; it has also involved tensions from time to time in U.S. domestic as well as foreign securities markets. Beneath the market surface are underlying economic forces working to correct the imbalances. In the U.S., the domestic saving gap is being reduced by restraint on budget deficits and also, it is to be hoped, by increasing private saving; resources are being shifted to export and import competing industries; productivity in manufacturing has been improved; and efforts have been made to restrain domestic spending. In Japan, the process of correcting imbalances has involved efforts to increase domestic spending and to open markets more. Over the longer run in Japan, I would expect the process will also involve other structural changes that will absorb domestic saving at home such as a reduction in the saving rate as the population ages as well as increased governmental social security payments. In the end, the U.S. will be making less of a claim on world saving, and Japan will have much less surplus saving to send abroad.

But the whole process of adjustment is still incomplete. And as it continues, it draws U.S. and Japanese financial markets closer together through the flow of funds out of Japan into U.S. securities market and also directly into industry; through the establishment of Japanese financial institutions in the U.S. as a natural by-product of that outflow of funds; and through the necessary opening and diversification of Japanese markets to accommodate the broader needs of their own borrowers and lenders as well as the reciprocal relationships with foreign investors and institutions as international competition intensifies.

Once the underlying imbalances in the saving processes of Japan and the U.S. are sufficiently moderated, the transitional period in which Japan is establishing itself as a key player in world finance will end, and financial market relationships between the two countries will take on a much more settled character. Flows of funds, for instance, will be more two-way rather than mainly from Japan to the U.S. and the rest of the world. The Japanese market itself, as the prevailing trend continues, will have adapted even more to the international market structure.

Globalization of Japanese Securities Markets and Industry

The Japanese and U.S. financial markets are similar in that both separate banking from the securities business. They are also similar in that the barriers are slowly eroding -- with a great deal of bargaining and negotiation taking place among the various private and governmental interested parties.

With regard to domestic deregulation in Japan in recent years, the banking industry has been the main focus as ceiling rates on deposits are gradually being lifted. The elimination of interest rate ceilings on larger deposits, the participation of Japan in the international agreement on bank capital, and the gradual activation of a short-term money market in Japan have brought the Japanese depository system, in terms of exposure to competitive pressures, more into line with other major countries.

The securities industry has not been, nor has it had to be, the main focus of domestic deregulation in Japan. The industry had been more or less free to operate within the constraints of the Japanese version of Glass-Steagall and subject to the regulatory overview of the Ministry of Finance. But globalization, associated international competitive forces, and the emergence of Japan as the leading net creditor nation have had a particular impact on the Japanese securities industry, bringing it much more prominently onto the world stage than it had been.

The sharp rise in price and in trading volume on the Tokyo Stock Exchange, the greater use of credit market financing in domestic and Euromarkets by Japanese and also non-resident businesses, and the expansion of governmental open market financing all strengthened the profitability of securities firms. Stock prices have risen throughout the decade but accelerated during the post-Plaza period of rapid rise in the yen when Japanese interest rates were further reduced. The yen had been greatly undervalued for some time, and its appreciation entailed a substantial further upward revaluation of all security market assets to levels more consistent with the underlying long-run strength of the Japanese economy.

In particular, with respect to securities firms, their capital base rose sharply relative to securities firms in the rest of the world. That provided a strong foundation for the outward thrust that was in any event necessitated by globalization. At the same time, of course, the Japanese market as it expanded became more and more attractive to foreign investors and firms. The yen became internationalized.

Establishment of Japanese securities firms abroad was in effect carried along by the immense outflow of longer-term capital from the country. By 1988, that outflow had risen from a small amount around the beginning of the decade to about $150 billion. The U.S. probably receives about half of the flow -- give or take some depending on circumstances of the particular year. Not surprisingly, major Japanese investment institutions -- such as insurance companies, trust accounts, and pension funds -- have rather steadily increased the foreign percentage of their total security assets.

As Japanese institutions have become more familiar with foreign markets, they have become more involved with a broader range of instruments and countries. Bonds remain the predominant focus of portfolio investment abroad. Japanese interest in foreign stock markets, with activity by far the greatest in the U.S. market, reached a peak in 1987, and ebbed following the crash. But the outflow of Japanese funds for direct investment abroad has been steadily picking up, representing about 23 percent of the long-term capital outflow last year.

The diversification and opening of the Japanese market have been matched by the diversification of securities companies into foreign markets and foreign activities. The major companies have sizable establishments in New York and London and have small subsidiaries or branches dotted throughout the rest of the world. To a considerable extent, now that Japanese industry and investors are moving abroad, securities firms have internationalized to maintain, and indeed protect, on a global basis customer relationships that have developed over the years in Japan. But doing business in foreign markets also inevitably entails development of a national customer base in those markets to some degree. That is necessary to acquire sufficient business acumen in the markets; to be established as a significant enough factor in the market to make services efficient and cost effective; and, more broadly, to be able to take advantage of the full possibilities of globalization.

The most recent phase of globalization has been characterized by, among other things, domestic interpenetration of each others market by globalizing securities firms. The movement of Japanese securities firms into the already relatively open U.S. markets has been accompanied by a parallel movement of U.S. and other firms into Japanese markets that have been in the process of opening for domestic and international reasons.

As of the end of May, there were 49 foreign securities companies with subsidiaries doing business in Japan, of which 20 were from the U.S.; most of the expansion in number of foreign firms has come in the past few years. Twenty-two of these firms, including 9 from the U.S., have become members of the Tokyo Stock Exchange; about 20 percent of the membership is now foreign. In the U.S., 13 Japanese securities companies operated subsidiaries as of April. Some were newly established in recent years. The larger ones had been here for some time, but have expanded their size and area of activity very considerably on balance over the past few years.

Despite the domestic interpenetration of markets associated with the current phase of globalization, it seems to me that it is very unlikely that foreign securities firms will become a dominant force in another country's domestic market. The strength of a foreign firm is its own domestic customer base and its expertise in its own market. Much of the business of foreign firms in another country's domestic market, therefore, is cross-border. For a Japanese securities firm located in the U.S., this would include sales of Japanese equities to U.S. customers, sales of U.S. equities and bonds to Japanese clients, and underwriting of offerings by non-Japanese firms in Euro and domestic Japanese markets. But some of the business, as noted above, is purely domestic in the host market, involving transactions confined to the U.S. domestic market with local customers. This would be the case for our firm, for example, in its primary dealer operation and also to a certain extent in equity and corporate finance activities.

In addition to cross-border transactions and domestic interpenetration of each other's markets as securities firms locate branches and subsidiaries in foreign markets, globalization today features expanded trading, and the potential for much greater expansion, of one country's domestic instruments in another country's marketplace. The Euro-dollar market has long since been established, and is essentially a U.S. domestic market shifted overseas. The Euro-yen market has been more recently established, in large part at U.S. urging. It has contributed to the internationalization of the yen and its success tends to bring pressure for change in the Japanese home market.

But domestic markets are now becoming even more intertwined with foreign customers and attitudes. U.S. Treasury securities now traded for cash in London and Tokyo, though the markets there are much less active and liquid than in New York. Still, when you come to work in the morning in New York, prices in the Treasury market may already be substantially different from the previous night's close, depending on developments in London and Tokyo. The basic trend of interest rates on U. S. Treasury securities is, of course, determined in the U.S. and by U.S. economic conditions and policies. However, the twenty-four hour market means that dollar activity in markets abroad has a distinct influence on the day-to-day volatility and profitability of short-run positions in the market here. It is technically possible, I should think, for similar developments to occur outside the Treasury market, most feasibly perhaps through further evolution of futures markets in non-local currency products here and abroad.

Market Policy Issues in Globalization

As securities markets become more closely interconnected around the world, as securities firms move into foreign markets, and as transactions in domestic instruments are effected within other countries' markets, a number of broad policy issues are raised. These issues revolve around the need for assuring the stability, liquidity and safety of markets and for seeing to fair treatment of each country's market participants in foreign countries.

First, though, I should say that the markets themselves have been handling the process of globalization rather well. There have obviously been market problems in recent years, but major problems have not by and large been the product of globalization as such. Insider trading abuses here, in Japan, and elsewhere have really been purely domestic market problems. The stock market crash of 1987 in the U.S. was mostly a domestic phenomenon, though spawned to an extent by fears of a breakdown in international economic cooperation. Globalization may well have affected the rapidity of mutually contagious effects on all stock markets around the world; nonetheless, the subsequent recovery of markets also illustrates their inherent resiliency as well as certain well-timed actions by monetary authorities. Security firms have also had well-publicized profit problems in foreign markets; they have been adjusting the role and scope of their operations more in line with the pace and patterns of market globalization.

In other words, market processes have been working to maintain a reasonably orderly process of globalization. But conditions have a greater chance of remaining orderly if there is enhanced cooperation among the self-regulatory and also relevant governmental bodies around the world. Responsible prudential standards in each market are now needed not only for the domestic purposes of each country, but also because of interactions with markets and instruments of other countries. Clearing and settlement issues, too, need to be well coordinated, and to a great extent mutually consistent, particularly in light of a growing tendency for domestic instruments to be traded in foreign countries. It is obviously to everyone's interest to ensure that the potential for delivery failures and settlement breakdowns are minimized. It is also to everyone's interest to assure that the minimum prudential standards on organized exchanges and over the counter markets are high enough so that any market participant tempted toward unsound practices in his or another country's market product will not find it easy to shift operations toward a weak link among national markets.

While it is most fruitful for the work to be carried forward by the private institutions actually involved, governments have an important oversight role to play. At a minimum, in a globalized market governments may be needed to ensure that international agreements suitably protect, or do not undermine, ultimate national interests.

With regard to the payments system, central banks, because they have the capacity quickly to fill gaps with unquestioned credit, are the ultimate guarantors against any breakdown that threatens broad-scale disruption. So they, collectively and cooperatively, need to develop, as they presumably have, a posture about who lends where under what conditions. But more importantly they and other relevant governmental and private bodies also need to develop payments system guidelines that minimize the chance of involving central bank credit -- since the need for a substantial, prolonged involvement by the central banks in itself can undermine confidence in the functioning of the private sector. So far as I can see, work appears to be underway in this area.

On prudential issues, the recent international agreement on bank capital indicates the possibility of international cooperation. A similar agreement might be developed for the securities industry, although issues there are even more complex because of the heterogeneity of the industry and markets and the diversity of regulators. Japan is in the process of modifying its capital requirements for securities firms so that they conform more closely to the U.S. and British models. This helps lay the basis for a broader international convergence of capital standard in the securities business.

It would be desirable for the various exchanges and self-regulatory bodies of major countries to work together toward minimum standards affecting market practice in other areas, such as financial disclosure, standards for listing, training for participants, etc. Obviously, such standards have long since been applied in major national markets, but international cross-checking is nonetheless important in view of the current globalization of national markets.

Questions about fairness of treatment across national markets are best handled, I believe, through application of the principle of national treatment. This is embodied in U.S. law and/or practice toward banking and securities markets. It is also the case in Japan. And I would hope it would be clearly adopted for the European community.

As compared with reciprocity as a principle, national treatment is much less ambiguous in practice and easy to administer; foreign firms simply are treated no differently from domestic ones. Problems can arise if domestic market attitudes and business practices tend to handicap foreign firms more in one country than another in efforts to compete with domestic firms in those countries. This may then require some reciprocal prodding in practice.

In any country a foreign securities firm will find it difficult to penetrate domestic markets because it lacks a broad set of domestic contacts and affiliation through which business might be readily generated. But given that very practical and universal constraint, national treatment generally yields the fairest results for foreign firms where markets are most impersonal and, within a country's institutional structure, most competitive.

Auctions and impersonal trading markets are generally easier routes for foreign firms to secure a reasonable base in another country's domestic market. In Japan, for example, the monthly offering of the key ten year bond issues is now forty percent auctioned (virtually all other issues are completely auctioned). This shift toward an auction in the ten year issue, together with an increased share for foreign firms in the syndicated portion of the issue, has enabled U.S. firms to secure a significantly larger portion of the action. In the most recent bidding, the largest share in the auction was won by an American firm according to press reports. Japanese firms have, as is well known, been sizeable participants in U.S. Treasury auctions for some time, and through their primary dealer operation in the U.S. have also actively attempted to expand the market for those securities through development of U.S., Japanese, and other foreign customers.

In sum, globalization, as it clearly brings world securities markets more closely together, will require more international cooperation and monitoring of market practices and standards. Nonetheless, markets are working well; they do not need substantial fixing. Still, market adaptations and adjustments to globalization do require enhanced cooperation. Discussions leading to decisions among self-regulatory agencies are the most effective route. But because national interests are involved, as well as some prodding of the private markets, intergovernmental oversight and bargaining is also required.

In that sense, one should note that in the U.S. we may not have quite adjusted to the closer relationships of internal markets and that may complicate international coordination in certain respects. As the stock market crash demonstrated and as is also amply demonstrated by daily trading in equity and Treasury security markets here, the futures and cash markets are really one. As they become even more involved internationally and with cross-border products, a more unified oversight domestically may help in coordinating global relationships more effectively.

I cannot avoid ending with the comment that orderly, stable global markets basically depend on the major nations of the world pursuing sound and cooperative monetary and fiscal policies. Without that, no amount or high quality of regulatory oversight, prudential standards, or capital requirements will guarantee market stability.

Senator **Dodd**. Thank you, Mr. Axilrod.
Lord Camoys.

STATEMENT OF LORD CAMOYS, DEPUTY CHAIRMAN, BARCLAYS DE ZOETE WEDD HOLDINGS LIMITED, LONDON, ENGLAND

Lord **Camoys**. Mr. Chairman, first of all, thank you for a very warm welcome. I appreciate that enormously. Believing as I do very much in the need for harmony, I also very much like your suggestion that perhaps there should be some joint sessions between parts of our two houses.

I am very unaccustomed to sitting on this side of the table and I therefore do feel rather daunted, so I would very much appreciate your indulgence as I try to help you.

It is my privilege and my pleasure, Mr. Chairman, to appear before you as the Deputy Chairman of Barclays de Zoete Wedd Holdings Limited and a Director of its parent Barclays Bank PLC.

Perhaps I may say at the outset that your letter of invitation covers a very wide range of areas. In the time available, it has been impossible to cover them in as much detail as we would have wished. I hope if there are any aspects of our views you wish us to clarify or cover in more detail after this hearing that you will not hesitate to ask.

I also wish to thank both John A. Kerslake, Chairman of the Institute of International Bankers and Chief Executive Officer for Barclays Bank North America; and Mr. Larry R. Uhlick, Executive Director of the Institute, for their assistance with my appearance before you today.

Global trading has become a reality in certain markets—government debt, swaps and foreign exchange in particular. This has largely been provoked by the requirements of the client and made possible by developments in systems and telecommunications. Save indirectly by the removal of exchange controls, international regulators have not led the move towards globalization. This should not worry us unduly. Product development demonstrates market health. Regulators should not seek to lead markets. And for this reason, they should not impede markets by erecting barriers which the clients regard as artificial, provided that the regulators are satisfied that the public interest is safeguarded.

Clients of the securities industry do require the efficient co-existence of markets; harmonization of regulation as well as market mechanisms is therefore desirable.

The Group of Thirty recommendations are central to improving the efficiency of markets and improving client confidence. Market mechanisms are basically sound but they are not universally efficient, nor are they internationally consistent. Undue delay between the date of dealing and the date of settlement inherent in some settlement systems creates intrinsic risk. So does delay in trade confirmation. The creation of central securities depositories in all of the world's leading capital markets would reduce risk since it would reduce delay. A rolling settlement system, based on delivery against payment, should be the norm in sophisticated markets.

The purpose of regulation is to promote competition for the benefit of clients, at the same time ensuring that the interests of clients and depositors are protected. Regulators I suggest should distinguish between measures directed at prudential security, and measures directed at creating level playing fields.

Harmonization of Regulation. Markets should operate in concern. Regulations should be harmonized better to enable the interests of multi-national clients to be services. The key principles are as follows:

Mutual Recognition. This will reduce layers of regulation and reduce costs. The goal should be that the regulators of Country A should have sufficient confidence in the regulators of Country B as to enable them to permit the regulators of Country B to regulate Country B practitioners operating in Country A. Only in this way, we believe, can regulators adequately monitor and control the activities of multi-service, multi-national financial services organizations. A system of delegation need not threaten the principles of national treatment (because control of all locally incorporated companies remains vested in the host supervisor). The Basle Accord demonstrates that this utopia is not beyond reach.

National Treatment. Host regulators must have the right to be as stringent as they wish in imposing regulations on domestic institutions and on legally incorporated subsidiaries of foreign institutions. But regulations should not be exported, nor should they be applied to institutions which are regulated by mother country supervisors (i.e. branches of foreign institutions).

Host regulators should allow foreign organizations the same latitude as their own nationals. If, however, the foreign regulators allow greater latitude than does the host regulator, the foreign organization should be permitted to operate under that greater latitude. As stated above, this is always subject to the supervening right of a host regulator to apply identical controls and restrictions to locally incorporated foreign subsidiaries as to domestic organizations.

Level Playing Fields. Practitioners should be able to compete on even terms for client business. This will improve the service given to clients. Where regulations are imposed on any class of practitioner in the interests of leveling the playing field, they should be applied to all practitioners.

Capital Convergence. The basis of the Basle Accord is that common international rules should be agreed, but that each nation should be free to impose stricter capital rules on its own institutions. Ultimately, signatories must have confidence that they can rely upon their co-signatories to supervise the activities of their constituent institutions in foreign jurisdictions. In addition, minimum capital requirements should be imposed on all domestic institutions—regardless of charter—which provide similar services to clients.

Market Access. The United States is the world's leading capital market. The interests of U.S. clients will be furthered by competition being stimulated between market practitioners. If clients cannot, because regulations prevent it, deal as they wish with financial services organizations in the full range of commercial and investment banking products, then they will tend to turn to those jurisdictions and those organizations (the universal banking groups) where such composite services are to be found. The fact is that from a practical point of view, commercial banking and investment banking are largely inseparable in the mind of the client. The corporate client is largely indifferent to source but rather more interested in service, quality, price and availability. By universal banking, I mean the combination in a group (albeit in separate legal entities within that group) of commercial and investment banking activities. We do not include in the definition the holding of long-term equity stakes in industry.

Simplicity. The quest for harmonization should not be unduly ambitious. International regulators should seek to agree on broad principles, not detailed rules.

Separation of Commercial Banking and Investment Banking. The interests of depositors cannot be hermetically sealed from the vicissitudes of the securities markets. The strength of commercial banks and the confidence of depositors is affected by movements in the securities markets. The stability of the securities markets is in part dependent upon the liquidity which the banking community is able to provide. Close relationships between banks and investment banks can serve to give confidence to turbulent markets. These relationships I believe do not, by themselves, create market turbulence.

Harmonization of financial reporting and disclosure standards will give corporates easier access to world markets and will enhance investor confidence. The extension of broadly common and consistent accounting principles and prospectus requirements to major capital markets will lead to a freer flow of capital throughout the world.

Fraud can be reduced by making criminals fearful of retribution. Practical demonstrations of international cooperation in fraud investigation will create that fear.

Tax. Governments can reduce the commercial uncertainty created by uneven cross-border tax treatment. In the interest of tax harmonization, bilateral tax treaties should incorporate the principle that the commercial result dictates tax treatment.

Cross-border Mergers and Acquisitions. Greater consistency in national systems of regulation and disclosure requirements is likely to lead to heightened levels of cross-border mergers and acquisitions. We have seen recent examples of the way in which multinational takeovers can run aground in the courts. The British Takeover Panel is now anomalous within the legal and regulatory climate in the City of London because it has no statutory role. But it is, in our view, an extremely valuable anomaly which should be preserved. We believe that the panel has served shareholders well. Central to its ability to exercise control in the highly charged atmosphere of company takeovers is its ability to command respect among market practitioners (which include non-British practitioners such as U.S. investment banks). Although decisions of the panel do not have the force of law, U.K. courts do appear to regard compliance with Takeover Code as setting a standard of reasonable behavior against which corporate actions can be measured.

Were a similar institution to be established in the United States, then it is certainly possible that this would make for greater market freedom, subject to the application of overriding legal principles. We recognize that it is unlikely, given the extent to which mergers and acquisitions are regulated in the United States by federal and state laws, that such a body could exist on a non-statutory basis. But the knowledge that there existed a statutory federal organization with responsibility for seeing fair play in takeovers in the United States would provide for more orderly markets and encourage higher levels of direct investment.

Reputation of U.S. Markets and U.S. Practitioners Overseas. We believe that the reputation of the U.S. financial services industry for competitiveness remains high, and this is true both of your practitioners and of the markets in the United States in which they operate. The most obvious way in which other major markets would seek to prevent entry by U.S. practitioners would be by raising the issue of reciprocity. The threat of the EEC playing the reciprocity card appears to have receded and we welcome this. There remains the risk that countries in which your financial services organizations wish to operate may create legal difficulties whilst the Glass-Steagall restrictions in the United States are preserved.

The threat to U.S. economic interests were your capital markets to lose their historical dominance would be considerable within the context of the budget deficit. But we see no evidence of long-term disenchantment among international investors with the U.S. markets. Nor do we envisage having to compete less aggressively with your indigenous securities houses, whose level of professionalism remains high and whose client appeal appears, much to our regret, to be undiminished.

Thank you, Mr. Chairman.

Senator DODD. Thank you very much.

We will now hear from Mr. Hennessy.

STATEMENT OF JOHN M. HENNESSY, VICE CHAIRMAN AND CEO-DESIGNATE, CS FIRST BOSTON, INC.

Mr. HENNESSY. Thank you, Mr. Chairman.

I'd like to begin by congratulating you for holding this hearing which examines the future of the world's securities markets.

We at CS First Boston have experienced first-hand the enormous changes in the world capital markets and we know that additional deregulation will inevitably occur. These changes pose great opportunities for American corporations as well as certain risks.

If you look at the deregulation of the last 15 years from the vantage point of hindsight, one has to conclude that following each major act of deregulation the same pattern has occurred, whether in the U.K., U.S. or international markets. There has been a rush to enter by new players, high-priced acquisitions of existing firms, initially large increases in new issue and trading volumes, followed by consolidation of the business into fewer and fewer dominant players, and eventually these make good returns on equity.

The bottom line is that deregulation has generally meant opportunities for the few and threats to many.

As deregulation of security markets continues around the world, I see no reason why this pattern will not reoccur. The deregulation of capital markets is significant, not just because they impact the way corporations and governments raise capital, but because they are catalysts behind major economic changes throughout the world.

Deregulation has shaped three major recent trends in business and industry.

First, there has been a dramatic increase in the flow of cross-border investment. The savings of one nation are now risked in the economy of another. There is no better example than investment patterns between the United States and our foreign economic partners. In the last eight years, U.S. investment abroad has nearly doubled and total foreign investment in the U.S. has increased sixfold.

Second, the world's financial markets have been both a catalyst and a showpiece for the free market revolution. The so-called Euro or international market exploded in size during the decade of the 1980s, as evidenced by new issues of debt and equity growing from an annual level of less than $20 billion in 1980 to over $170 billion by the end of 1988.

Third, survival for most industries now is no longer guaranteed by a dominant domestic role. It is now essential in more and more businesses to extend that dominance to all the major industrialized nations as well as emerging ones. The business leaders and entrepreneurs spearheading this worldwide capitalist perostroika have realized that successful companies must be at the same time intensely local and intensely global.

For example, last April, Rupert Murdoch speaking on this in London stated unequivocally that he believed there would be only seven world-scale media companies by 1995. We see today the process of that consolidation is going forward, as Senator Heinz referred to earlier. The growth of mergers and acquisitions is one major result.

What does the future hold? There are three potential major future areas of deregulation still facing us—Glass-Steagall in the U.S., Article 65 in Japan, and EC 1992 in Europe. Let me begin with the single European market, EC 1992.

With a market of 320 million consumers compared to 250 million in the United States and 122 million in Japan, the investment banking securities opportunities appear on the surface unlimited. Each of the European domestic capital markets, however, is in fact quite small, most without liquidity or breadth. Long-term bond markets, except for government bonds, basically do not exist in Europe. For this reason, European firms seem to be at a distinct disadvantage in terms of access and cost of capital compared to their Japanese and U.S. rivals. In view of this, one would expect there would be great pressure for further major deregulation in Europe.

Thus far, however, the idea of creating one homogeneous European securities market by linking the major exchanges and writing one set of rules does not seem to be in the cards, not for 1992 or even 2002. The exchanges view themselves in competition with each other and each nation has innumerable restrictive practices that date back often centuries, particularly as they apply to rules of stock issuance and stock ownership.

Even though competition from London and further deregulation in the U.S. and Japan will create great pressure to unify, I believe that deregulation in continental Europe will be slow, piecemeal, and uneven in the securities business. At worse, 1992 will result in a fortress Europe, a market less open to outside investment, with the bureaucracies of Brussels dominating the process.

If this is the case, the opportunities and threats in the European securities markets to non-participants will be on a much smaller scale than perhaps elsewhere. Most major players, ourselves included, will nonetheless try to participate in it, but on the cheap, without trying to mount full-scale securities operations in most of the twelve member nations. While the upside of opportunity of this approach is less, probably so is the risk.

Six thousand miles away from Brussels in Japan, internationalization of the market is also seizing the banking industry. In 1978, there were 53 foreign banks and only 2 foreign securities firms licensed in Japan. Today, there are 82 foreign banks and 49 foreign securities firms. Looking to the future, the Ministry of Finance, the MOF, has focused on deregulation of the securities and banking industry.

In Japan, the debate has shifted from commercial banks merely gaining entry into the securities markets to the establishment of the conditions under which commercial banks can compete. We do not expect, however, sweeping deregulation U.K. style. The profitability for Japanese banks and brokerage houses is just too high for the Ministry of Finance to throw open its doors to the world, and evolutionary change is much more in keeping with their national character.

I do think we will see many U.S. commercial and other countries' banks enter the Japanese market when Article 65, the Japanese equivalent to Glass-Steagall, changes. Right now, many of us who are members of the Tokyo Stock Exchange are quite satisfied and perhaps, to our surprise, find we are making reasonable returns for three reasons.

First and foremost, in the domestic equity market there still exists a fixed commission system which basically provides good margins.

Second, global investment management is a product we can offer which is not generally available from Japanese firms and is in high demand.

Finally, foreign M&A is rapidly becoming a sunrise industry in Japan.

Nevertheless, the costs of establishing an effective operation in Tokyo are several times higher than any other market in the world, and the cultural barriers to doing business domestically are even higher than in other countries. Second, once Article 65 is dismantled, the rich commissions of Japan will likely follow the course of the U.S., U.K., and Europe. Finally, the post-Article 65 era will undoubtedly bring stiff competition from the Japanese city banks and insurance companies.

Now what do I think is the future of our domestic securities market?

I believe even if Glass-Steagall is fully eroded, the remaining regulatory framework will likely prevent any substantial change in the domestic market. One must recognize that even with full Glass-Steagall deregulation there will remain a set of practices and regulations which have grown up around the 1933 Securities Act which severely affect the economics of entering the securities business.

These regulations fail to recognize that we need to respond to two distinct markets—a domestic market of individual investors who need certain protections, and an international market comprised of large, sophisticated institutional investors.

These restrictions in fact have disintermediated the U.S. as a natural center of world capital markets, at a time when the dollar is clearly the world's common currency and borrowing vehicle.

The SEC has proposed a bold step known as Rule 144A to make our markets more efficient and at the same time refocus the SEC's efforts on their primary mission—protecting the small individual investor. Rule 144A would allow sophisticated institutional investors to trade directly with issuers without having to negotiate through the SEC. This proposal recognizes the current reality, which is that almost all privately placed securities are done with large institutions. And, as we heard from Mr. Ruder, 80 percent of all New York Stock Exchange trading is also done by institutions today.

If this type of common sense deregulation occurs, then I would reverse my prediction and submit that the opportunity in the U.S. market for all participants and the process of capital formation will be greater than any other deregulated market today.

If it does not occur, the international market will eventually provide the answer through the linking up via systems like Reuters, and of the various equity and options markets, so that there will be a worldwide electronic over-the-counter market. This process, as we've heard, has already begun.

In conclusion, I believe that the continued globalization of the securities market and the economic interdependence that comes with the free flow of capital is now inevitable.

I also believe that as more barriers between commercial and investment banking are dismantled, the U.S. will have to act. I hope that we act to protect the sanctity of the system, not by overregulation, but by the types of recommendations for international cooperation advanced by the Group of thirty. As the world's securities markets continue to deregulate, it is important that our government lead in addressing these issues and not react to crises.

Again, Mr. Chairman and Subcommittee Members, I would like to congratulate you for your leadership in exploring the government's role in an ever-changing global securities system and I would be pleased to answer any of your questions.

[The complete prepared statement of John M. Hennessy follows:]

Testimony of John M. Hennessy

Vice Chairman and CEO-designate

CS First Boston, Inc.

before the Subcommittee on Securities of the

Senate Committee on Banking, Housing and Urban Affairs

June 15, 1989

CS First Boston

SUMMARY

STATE OF INTERNATIONAL MARKETS

Technological changes in the 1980's resulted in the dismantling of impediments to cross-border capital flows. The prior regulatory framework could no longer be justified in a global market, so nations responded:

- Withholding taxes on foreign-earned interest income and foreign exchange controls were repealed, further increasing securities trading outside domestic markets.

- The Big Bang of October, 1986 drew many new entrants into the U.K. securities market until the October, 1987 stock market crash. The crash left London securities traders with a $2 billion loss as over-capacity became manifest.

The pattern of major deregulation in the past is a rush of new entrants, high priced acquisitions of existing firms, initial increases in prices and volume, followed by consolidation into a few profitable firms. This pattern likely will be repeated in the future.

BUSINESS TRENDS

Securities deregulation has shaped three major business trends:

- The explosion of cross-border capital flows -- The investment patterns with our economic partners demonstrate the dramatic increases in U.S. investment overseas, and foreign investment in the U.S. Cross-border capital flows swelled in direct (plant and equipment) and portfolio (corporate debt and equity) investments.

- The emergence of borderless financial markets -- The volume of new issues in the unregulated international Euro market has increased five-fold in the last eight years.

- The worldwide restructuring of business (global capitalist perestroika) -- Survival for most industries is no longer guaranteed by a dominant domestic role. Successful industries must now extend dominance to all major industrialized countries. One result is an increase in mergers and acquisitions -- but the ability to pursue mergers and acquisitions varies in different parts of the world.

FUTURE DEREGULATION

EUROPE:

EC 1992 will not create a homogeneous European securities market because the exchanges view themselves as competitors and their many restrictive practices are well ingrained. EC 1992 may lead to a "Fortress Europe" -- a securities market dominated by the supremacy of the bureaucracy in Brussels -- with major securities firms unwilling to mount full-scale operations.

JAPAN:

The Ministry of Finance (MOF) has focused on securities and banking deregulation. Because of high fixed commissions and rapidly growing merger and acquisition activity, foreign firms are making reasonable returns. Because of the high profits earned by Japanese firms and the nature of the Japanese, deregulation will be evolutionary. However, there is great potential business opportunity in the Japanese market.

UNITED STATES:

Even if Glass-Steagall is eroded, the remaining regulatory framework will likely prevent any substantial change in the domestic market:

- The performance of major securities trading houses has declined dramatically;
- The volume of new issues is in decline;
- The ability to innovate has been much more central to success than any changes in laws and regulations.

The current regulatory framework fails to recognize the different needs of large sophisticated institutional investors who comprise the international market, and individual investors whom the traditional SEC regulations were intended to protect.

We need to eliminate unnecessary regulations which impose additional costs only in domestic markets penalizing U.S. securities firms by driving business overseas. For example, proposed SEC Rule 144A would allow the U.S. to become the world's central marketplace by allowing domestic and foreign issuers to issue less expensively in the U.S. market. If this does not occur, the market will achieve a similar result by linking up via systems such as Reuters.

THREATS TO THE SECURITIES SYSTEM

The October 1987 Crash demonstrated the need to integrate and improve the clearance and settlement practices which differ among countries. In too many countries the practices and procedures have not kept pace with the internationalization of the industry. The Group of Thirty has offered numerous recommendations to protect the integrity of the system. The Committee should encourage cooperation and coordination between federal agencies and our trading partners without adding additional bureaucratic layers. The approaches such as S. 646, the "International Securities Enforcement Cooperation Act" should be explored.

CONCLUSIONS

- The profit opportunities for securities firms will potentially be the greatest in Japan;

- The U.S. regulatory framework needs to adapt to today's global markets by responding to the needs of sophisticated institutional investors - - such as through adoption of Rule 144A;

- There is a threat to the system from the technical and credit aspects of the market - - we need to provide leadership to develop world coordination and cooperation, not additional regulation.

Mr. Chairman and members of the Subcommittee, I congratulate you for holding this hearing examining the future of the world's securities markets.

I am Vice Chairman and CEO-designate of CS First Boston Inc. First Boston is a full-service international investment banking firm serving both suppliers and users of capital around the world. Through its wholly owned subsidiaries -- The First Boston Corporation in the Americas, Financiere Credit Suisse-First Boston in Europe and the Middle East, and CS First Boston Pacific in the Asia/Pacific Region -- CS First Boston provides comprehensive financial advisory services and develops innovative financing approaches for a broad range of entities. The firm employs its own capital resources to trade and underwrite securities and to engage in merchant banking and other principal transactions.

We at First Boston have experienced firsthand the enormous changes in the world capital markets, and we know that additional deregulation will occur. These changes pose tremendous opportunities for American corporations as well as certain risks. Today I will share with you some of my own thoughts on the future of these markets and the opportunities they offer. They will be highly influenced, or prejudiced as you will, by my having lived and worked on Wall Street during its greatest period of deregulation -- May Day 1975, followed by the adoption of Rule 415 in the U.S. in 1983, and then having worked in London during its period of intense deregulation, pre- and post-big bang of 1986. I can say that deregulation always invites major painful restructuring of an industry, with many of the benefits being achieved only over the long term.

Mr. Chairman, the world's securities markets have dramatically changed in the decade of the 80's and are certain to become even more globalized as we enter the next century. These changes are significant, not just because they influence the way corporations and governments raise capital but because they are the catalyst behind major economic changes throughout the world.

If the United States is to remain competitive as an economic leader in the world marketplace it is important for policy makers to appreciate the changes which are taking place worldwide so as to promote our own economic strength. As barriers to the free flow of capital are dismantled by our trading partners, and further deregulation proceeds, we must be prepared for new challenges and the painful side effects.

STATE OF INTERNATIONAL MARKETS

Let me start with a quick review of the last eight years with regard to what has occurred in the international securities markets -- the off-shore Euro- and international markets, the most unregulated securities markets in the world.

Beginning in the mid-1980's, there was a series of very important changes in the financial markets in different parts of the world. The result is that capital flows are no longer constrained by political boundaries. Cross-border transactions have become the rule rather than the exception, and must be taken into account when pricing any security in any market.

This new reality is driven not by deregulation -- which is a consequence, not a cause -- but rather by advances in technology. These advances, in computer and communication technology, have substantially altered the flow of information. Markets now react to instantly communicated information from around the world. Because of this technological revolution the prior regulatory framework, confined to national borders, could no longer be justified because it merely impeded activities which global markets demanded. The result was the dismantling of impediments to cross-border capital flows. For example, the U.S. and several European states removed the withholding tax on interest income earned by foreigners, and foreign exchange controls that had existed for decades in most of the industrial nations were abolished.

As you are fully aware, the great growth in the size of the marketplace was accompanied with great innovations in financial instruments. Swaps and hedging strategies became a major feature of a vast majority of debt security offerings. Equity warrants and options which had been out of vogue became commonplace and were often the difference between closing a deal or not. This deregulation and explosion in capital flows across borders resulted in an enormous expansion of human and physical resources and related services at international securities firms located in the major financial markets, especially in London. The creativeness of this market in the early 1960's was a direct result of capital restrictions put on in the United States to try and keep capital walled up at home. As a result most of the profitable international capital market business moved to London.

The second major area of deregulation in the 1980's was the complete abolition of all restrictions on entry to the U.K. domestic securities market -- the so-called Big Bang of October 1986. The immediate impact was the headlong rush by foreign commercial banks -- American, British, and Swiss -- to acquire U.K. equity brokers and equity trading firms at very high earnings multiples. For the early entrants, the first year-- roughly from the Big Bang of October 21, 1986 until October 19, 1987 -- was a time of increasing new issue and trading volume with apparently riskless profits.

While foreign (non-U.K.) security firms by-and-large did not acquire local U.K. firms, security firms indulged ourselves, by rapidly expanding existing operations there. For example, we entered the U.K. government bond market; 27 market makers were approved by the Bank of England in comparison to the three or four dominant ones that existed previously -- with sad results. The Crash of October, 1987 took the liquidity out of the international markets, much more than in domestic markets. Trading and new issue volumes dropped, spreads narrowed or disappeared, and over-capacity which had been hidden by the explosive growth became manifest. According to the Economist magazine, the major U.K. domestic market and Euro-market players in London have lost approximately $2 billion since 1986.

In summary, if you look at the deregulation of the last 15 years from the vantage of hindsight, one has to conclude that following each major act of deregulation the same pattern has occurred -- whether in the U.K., U.S. or international markets. There has been a rush to enter by new players, high-priced acquisitions of existing firms, initial large increases in new issue and trading volumes, followed by consolidation of the business into fewer and fewer dominant players who eventually make good returns on equity. The bottom line is that deregulation has generally meant opportunity for the few and threats to the many.

As deregulation of securities markets continues around the world, I see no reason why this pattern will not re-occur.

BUSINESS TRENDS

The deregulation of capital markets has shaped three major trends in business and industry. They are:

- the explosion of direct investment across international borders;
- the emergence of a borderless world capital market; and

- the world-wide restructuring of business -- a capitalist perestroika.

1. Explosion of Cross-Border Investment

The dramatic increase in the flow of cross-border investment is the best demonstration of the new financial world, where the savings of one nation are risked in the economy of another. There is no better example than investment patterns between the U.S. and our foreign economic partners.

At the start of the 1980's, the total amount of foreign direct investment (plant and equipment) and portfolio investment (corporate debt and equity) in the U.S. was $54 billion and $53 billion, respectively. By the start of 1989, total foreign direct and portfolio investment in the U.S. increased six-fold to estimated total levels of $320 billion and $370 billion, respectively.1/

Likewise, U.S. investment in foreign countries exploded. At the beginning of 1980, U.S. direct investment in foreign countries was $187 billion and portfolio investment was $57 billion. By 1988, those total levels of U.S. foreign investment had swelled to $308 billion and $147 billion, respectively.2/

These trends were not just in the U.S. Japan, which couldn't afford to invest in foreign markets in the early post-

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1/ Source: U.S. Department of Commerce, Bureau of Economic Analysis.

2/ Source: U.S. Department of Commerce, Bureau of Economic Analysis.

war period, in fiscal year[3] 1988 alone, made investments worldwide of over $47 billion in net new purchases of plant and equipment and a further $90 billion in foreign securities.[4] By 1987, the amount and pace of gross cross-border world flows of capital had greatly expanded and were estimated to be up to twenty times world trade levels of $2.5 trillion.

The dramatic change in investment patterns has stemmed from the gradual breakdown of strict foreign investment controls. Whereas corporate and individual savings were once considered heirlooms to be kept at home, by 1992, all major industrial nations will have abolished all capital controls. While trade fueled world economic growth for the first 35 years after World War II, it is now capital flows that are the true lifeblood of today's global economy.

2. Global Financial Markets

The world's financial markets have been both the catalyst and the showpiece for the free-market revolution. The 1980's have wrought a whirlwind of change in these markets.

The so-called Euro or international market expanded during the decade of the 80's, as evidenced by new issues of debt and equity growing from an annual level of less than $20 billion in

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[3] Fiscal years in Japan end March 31.

[4] Source: Japanese Ministry of Finance (MOF).

1980 to over $175 billion by the end of 1988.[5] And, even though a trillion dollars in new issues of securities has taken place during the 1980's in this unregulated international marketplace, it has been virtually fraud-, failure- and scandal-free -- a record, unequaled by any domestic market during the same period.

3. A Global Capitalist Perestroika

One reads almost daily in the press about the restructuring of the Russian economy -- but interestingly, we read very little about the great capitalist perestroika that is occurring in the free world. Gorbachev's perestroika is today hanging in a delicate balance, while nothing seems able to quell the momentum and energy of the free market and the entrepreneur.

Survival for most industries is no longer guaranteed by a dominant domestic role -- it is now essential to extend that dominance to all major industrialized nations as well as emerging ones. For example, last April Rupert Murdoch stated unequivocally that there would be only seven world-scale media companies by 1995. This applies to many other industries as well. The business leaders and entrepreneurs spearheading this worldwide perestroika have realized that successful companies must be intensely local and intensely global at the same time -- an apparent contradiction wherein lies the formula for success.

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[5] Source: OECD Financial Statistics Monthly verified within acceptable ranges with IMF International Capital Markets and Bank for International Settlement. An international bond, or Eurobond, is defined as one that is simultaneously placed on the market of at least two countries and is denominated in a currency that need not be of either.

The growth of mergers and acquisitions is one major result. But the ability to pursue freely an acquisition growth strategy differs widely in the various parts of the world. Undoubtedly the most open market is the United States, particularly for large transactions. Foreign acquisitions of American companies in 1988 exceeded $55 billion, more than double the 1986 total. The deals are getting larger, they are frequently hostile and they often involve foreign companies willing to pay large premiums based on strategic goals rather than near-term cashflow considerations.

But American business is by no means out of the race. The Time-Warner Communications Inc. announced merger and recent American purchases/joint ventures with major European companies demonstrate that the battle has heated up. As a result, we will see many more American corporate forays into the European continent as 1992 approaches. I believe American enterprise will once again emerge as a leader in the race for global business. But it is by no means a foregone conclusion. In this era of global perestroika, the race will be hard, the competition intense.

FUTURE DEREGULATION

Having explained the deregulation which has clearly taken place and the corresponding business trends, what does the future hold?

There are three potential major areas of deregulation still facing us: Glass-Steagall in the U.S., Article 65 in Japan, and in the EEC the breaking down of the innumerable practices, inefficiencies and restrictions that still exist in each of the eleven EC nations - excluding the U.K.

1. Europe

Let me start with the single European Market - EC 1992. EC 1992 is no longer just an idea, it is fast becoming a reality. Even though the single market will not be fully in place by January 1, 1992, or even later, it has begun an irreversible movement --- it has changed the way people think about business and their future in Europe. It is a matter of great importance for America and American business.

Why?

Because a race is on -- Europe is on the move and will be a third force to contend with in the late 1990's -- along with the United States and Japan. American business will either be a major player, a front runner, in this race or see its business position eroded -- not just abroad but at home as well.

"In theory", the general goals of EC 1992 are clear -- to create a unified market without frontiers for goods, services, capital and labor. If this is accomplished, Europe could become the single richest marketplace in the world.

"In reality," however, EC 1992 could become a "Fortress Europe." The integration of Europe will either be a continuation of the trend towards internationalization, reaching from New York to Japan to London, emphasizing competition, deregulation and the private sector; or it will result in a Europe less open to outside investment with the oppressive hand of government and bureaucracy dominating the process.

What does EC 1992 mean for the securities industry?

With a market of 320 million consumers, compared to 250 million in the U.S. and 122 million in Japan, the investment banking/securities opportunities appear, on the surface, unlimited.

Each of the European domestic capital markets, however, is small -- most without liquidity or breadth -- and long-term bond markets, except for government bonds, basically do not exist. For this reason, European firms seem to be at a distinct disadvantage in terms of access and cost of capital compared to their Japanese and U.S. rivals. In view of this, one would expect there to be great pressure for major deregulation.

The EC Commission says that by removing the barriers in the financial services industry, consumers will save over $35 billion. This savings should provide a large source of new investment capital and generate a third of the expected 3.5% or more increase in economic growth. Higher GDP and employment, lower costs, and better product quality ultimately depend on providing the lowest cost, and most effective form, of capital--particularly risk, seed and restructuring capital. In 6 years spent there, I was struck by the virtual lack of entrepreneurial and risk capital -- hallmarks of the late 70's and 80's growth in the U.S. economy. In short, financial liberalization will benefit all primary and secondary users of financial capital markets from corporate issuers to institutional investors to individual depositors.

Thus far, however, the idea of creating one homogeneous European securities market -- either by linking or fusing the major exchanges and writing one set of rules for disclosure, listing, and trading with one set of settlement and clearing mechanisms -- does not seem to be in the cards for either 1992 or even 2002.

The Exchanges view themselves in competition with each other, and each nation has innumerable restrictive practices that date back often centuries, particularly as they apply to rules of stock ownership. Thus, I believe deregulation of the securities business in continental Europe will be slow, piece-meal and uneven -- in spite of the euphoria surrounding 1992. At worst, 1992 will result in more regulation of securities markets, including the Euro-market, if the supremacy of the bureaucracy in Brussels prevails. A United States of Europe in the securities market is not likely in this century, even though competition from London and further deregulation in the U.S. and Japan will create great pressure to unify.

If this is the case, the opportunities and threats in the European securities markets to non-participants will be on a much smaller scale than perhaps elsewhere. Most major players, ourselves included, will nonetheless try to participate in it but on the cheap, without mounting full-scale securities operations in most member nations. While the upside or opportunity of this approach is less, probably so is the threat.

2. Japan

As we all know, internationalization of the market is swiftly shaping Japan's banking business and forcing circumvention of existing securities regulation. In 1978, there were 53 foreign banks and two foreign securities firms in Japan -- today there are 82 foreign banks and 49 foreign securities firms.[6/]

Looking to the future, the Ministry of Finance (MOF) has focused on deregulation of their securities and banking industry. The debate has shifted from banks merely gaining entry to the securities markets to the establishment of the conditions on which commercial banks can compete. This is well ahead of changes in Glass-Steagall, which makes it highly improbable that

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[6/] Source: Japanese Ministry of Finance (MOF).

the U.S. will act before Japan. We don't expect, however, sweeping deregulation -- U.K. style. The profitability for Japanese banks and brokerage houses is just too high for the MOF to throw open its doors to the world, and evolutionary change is much more in keeping with the national character.

In Japan, the profit opportunity is different from Europe and the U.S., largely because of the existence of fixed commissions on stock purchases and sales. The deregulation of Japan's securities markets offers the opportunity to compete for the $8.6 billion and $7.6 billion of pre-tax profits earned by the big four alone in 1987 and 1988, respectively. They have 70% of the underwriting and 50% of the trading market share while the remaining firms share the balance.

I think we will see many United States and other commercial and investment banks enter the Japanese market when Article 65, the Japanese equivalent to Glass-Steagall, changes. Right now, many of us who are in the Tokyo stock market are quite satisfied and, perhaps to our surprise, we are making reasonable returns for three reasons: first and foremost, the fixed commissions in this domestic equity market provide good margins; second, global investment asset management is a product we can offer which is not available from local firms and is in high demand; finally, foreign M&A is rapidly becoming a Japanese sunrise industry.

However, the costs of establishing an effective operation in Tokyo are several times higher than those of any market in the world and the cultural barriers to doing business domestically are much higher than in the U.S. Second, once Article 65 is dismantled, the rich commissions of Japan will likely follow the course of the U.S., U.K. and Europe. Finally, the post-Article 65 era will bring stiff competition from Japanese city banks and insurance companies.

3. United States

While the U.S. Glass-Steagall separation of commercial and investment banking has been eroded more through outright modifications and administrative rulings than has Article 65 in Japan, the exclusion of commercial banks is still real for most key sectors of securities business activity.

Looking to the future, I expect that Glass-Steagall will continue to be eroded in the next three to five years, as much from pressure outside the U.S. as from inside -- after Japan acts on Article 65, the U.S. would be the sole segmented securities market.

What does deregulation mean in the U.S.?

Even if Glass-Steagall were to be fully eroded, the remaining regulatory framework will likely prevent any substantial change in the domestic market. I expect, for instance, firewall provisions requiring separate and competitive levels of capital of participating firms; functional regulation of these activities by the SEC; and, perhaps, even size or concentration restrictions on those foreign institutions who wish to operate in both the banking and the securities arenas. These types of regulations will severely affect the economics of entering the securities business.

Further entry into the securities business, even on a fully level field, would not be the bonanza many expect, for the following reasons:

First, the performance of the major securities trading houses, measured by return on equity, dropped from the heady ranges of 10% to 25% for the ten year period from 1976 to 1986 to a range of 2% to 8% in 1988 and the first quarter of 1989.[7/]

Second, new issue and trading volume is in decline, especially in the area of common equity. In 1986, $43 billion of new common equity was issued, $41 billion in 1987, $30 billion in 1988 and $3.9 billion in the first quarter of 1989 which, if annualized, suggests a paltry level of $15 to $16 billion of new issues for 1989.[8/]

Third, the ability to innovate has been much more central to success in the securities business in the last 15 years than any changes in laws or regulations. The high-margin businesses of the decade have been mortgage-backed securities, swaps, junk bonds, L.B.O.'s, and M&A. In all cases, these businesses have

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[7/] Source: Securities Industry Association. Includes business done only through domestic broker/dealers capturing approximately 65% to 70% of industry revenue in the period referred to.

[8/] Excludes Closed-End Funds.

been led by the four or five firms who got in early, innovated, developed their product and then dominated the business. They achieved success and dominance not because they were protected from competition by regulations, but because others found it impossible to replicate the human talent, technical infrastructure and experience which were, and still are, required to succeed.

Fourth, with the possible exception of Drexel Burnham in junk bonds, the firms that were dominant in the U.S. at May Day 1975 are those which are still dominant today. The same is true basically in pre- and post-Big Bang U.K. Furthermore, today the major threat to the securities industry's high margin businesses is not, in my judgment, deregulation or the second tier full service securities firms, but the older niche players and the new ones -- the "boutiques" -- who have all the advantages of specialization without the historic overheads.

By this time, you have no doubt guessed that I see very little opportunity for the market itself, or for its players, in the easing of Glass-Steagall per se, and one must recognize that even with full Glass-Steagall deregulation there will remain a set of restrictive practices and regulations which have grown up around the 1933 Securities Act. These regulations fail to recognize that we need to respond to two distinct markets: a domestic market of individual investors who need certain protections, and an international market comprised of large sophisticated institutional investors. These restrictions in fact have disintermediated the U.S. as the natural center of world capital markets -- at a time when the dollar is still clearly the world's common currency and borrowing vehicle.

For example, the restrictions imposed on all foreign issuers in the U.S. securities market -- even AAA ones -- such as GAAP accounting standards, the SEC's complex disclosure requirements, the constant threat of U.S.-type liabilities and litigations, means that today no single large, liquid world market in equity securities yet exists. The international 24-hour trading market lost its liquidity after October 19th, and each of the other domestic markets is too small to serve as the world's central marketplace -- only the U.S. could do so at the present time.

No one would suggest that we should have a totally uncontrolled market with whatever abuses follow. But we must view regulations as a balancing of interests, and be aware that these interests have changed as the markets have crossed political borders. I believe that we need to review our own regulatory framework to ensure that we protect the safety of the markets without erecting unnecessary barriers against foreigners issuing in our own markets. We shouldn't penalize U.S. securities firms by driving business overseas.

The SEC has proposed a bold step known as Rule 144A to make our markets more efficient and at the same time to refocus the

SEC efforts on their primary mission, which is to protect the small, individual investor. The proposed rule would allow sophisticated large institutional investors to trade directly with issuers and not to waste the resources of the government and the taxpayers by negotiating through the SEC. This recognizes the current reality, which is that almost all private-placed securities are done with large institutions and 80% of all New York Stock Exchange trading is also done by institutions. This rule, if adopted, will free up the resources of the SEC to focus their protection on individual and small investors and traders which was precisely the intent of the original 1933 Act.

Adoption of Rule 144A would broaden the market and allow domestic and foreign issuers to issue frequently and inexpensively, and at the same time within the legal and market framework of the United States.

If this common-sense deregulation occurs, then I will reverse my prediction and submit that the opportunity in the U.S. market for all participants will be greater than in any other deregulated market to date. If it does not occur, the international market will eventually provide the answer through the linking up -- via systems like Reuters -- of the various equity and options markets so that there will be a world-wide electronic O.T.C. market. This process has already begun.

THREATS TO THE SECURITIES SYSTEM

Finally, when evaluating the opportunities and threats of a deregulated worldwide securities market, we have to add to our list the sanctity of the system itself.

The Crash of October, 1987 demonstrated that the world's capital markets today are closely integrated -- events in one part of the world can shake the rest. As discussed above, the Crash brought massive losses to Euro-market players in London. But more importantly than demonstrating the integration of the world's markets, the Crash tested the sanctity, if not the very existence, of the system and it survived.

But there is still a large item of unfinished business. You'll remember that we learned from the Brady Commission that, due to unlinked and inadequate clearing, settlement and information systems both within and across markets, the worst aspect of the October 1987 collapse was not that the stock market crashed but that we pushed the U.S. and other securities systems to the verge of collapse and put our national banking system on the brink.

Today each country has its own clearance and settlement practices for security transactions. For example, settlement periods vary from same day to several weeks; trade guarantees are not uniform; exchange of securities and payment practices can leave one party to a transaction exposed; and many markets lack book entry, i.e. computerized, settlement processing. In many markets, these technical aspects of securities trading have not kept pace with the internationalization of the industry. Practices and procedures that may have made sense for a domestic market are totally inadequate for trading securities on a global scale. The issue is not mere inefficiency, but risk. For example, the quick physical movement of securities and cash payments is simply not feasible from one hemisphere to another.

The Group of Thirty, a private sector group concerned with the workings of the international financial system, recently reported on the need to adopt an international set of clearance and settlement standards and practices. For example, they recommend that trade comparisons be accomplished by the next trading day to accelerate settlements, thereby reducing risks associated with outstanding trades. Another recommendation is the adoption of book entry transactions. These recommendations are aimed at protecting the world's capital markets.

Mr. Chairman, our domestic market is neither the best nor the worst in developing and adopting these practices. But we need to be leaders in the development of a global marketplace with an integrated system. We need to do more to encourage the use of these practices by our trading partners.

I believe that this Committee can do much to encourage our own government to assume a leadership role in coordinating the adoption of international measures such as the types recommended by the Group of Thirty. Coordination should be accomplished not by adding a new bureaucratic mechanism. Instead, the SEC, the CFTC, the SROs should work together to develop and implement a strategy for international coordination.

The approach of S.646, the "International Securities Enforcement Cooperation Act of 1989" is an example of the type of leadership that our country should display in meeting the challenges of a global securities market. This measure offers one valuable means to strengthen international cooperation in enforcing securities laws. It would permit the SEC to honor confidentiality requirements of other countries when sharing evidence. It would also promote cooperation in policing the employment of securities professionals.

Mr. Chairman, I know that these are rather arcane and technical issues. But I submit that we simply cannot afford to await another crisis, such as the October Crash, to begin to move forward. Until exchanges around the world improve and completely secure the technical, credit and mechanical aspects of their operations, there will be an unmeasurable element of risk in the equation.

CONCLUSION

I believe that the continued globalization of securities markets and the economic interdependence that comes with the free flow of capital is inevitable. I also believe that as more barriers between commercial and investment banking are dismantled the U.S. will have to react. I am concerned that the reaction may be to overregulate. As the world's securities markets continue to deregulate, it is important that our government lead in addressing these issues, not react to crisis.

Let me summarize my conclusions:

- In spite of deregulation yet to come in Europe, Japan and the U.S., the threat of high overheads and low margins is as vivid as the profit opportunities from huge new issue and trading volume. For foreigners who choose to play in a big way in other domestic markets, the threat is probably greatest. For commercial banks who have to enter a new and, I stress, very different business, as well as new markets, I ask whether the game will be worth the prize -- even in the U.S. market. In my opinion it should be done only in stages, and only with separate and equal capital requirements for commercial banks to those existing in the securities industry for that part of the business.
- The profit opportunities for securities firms will potentially be the greatest in Japan, but it is highly unlikely that any foreign commercial or investment bank will be able to seize them fully -- largely due to cultural factors.
- While there is a real threat to the system from the technical and credit side, this is not the threat most regulators worry about. They fear there are not enough rules and no master

regulator. If they fix the second instead of the first, the whole business will suffer.

- The U.S. regulatory framework needs to adapt to the global markets of today by responding to the needs of large sophisticated institutional investors, for example through Rule 144A.
- As in the past, there will always be great opportunities in the securities business for those firms that (a) have or create profitable niches, or (b) have dominant market shares in major product areas to build on and are, or become, low cost producers on a world-wide basis.

Again, Mr. Chairman, I congratulate you for your leadership in exploring the government's role in an ever-changing global securities system and would be pleased to answer any questions the Committee has.

Senator **Heinz**. Well, gentlemen, thank you very much. Chairman Dodd has been called to a leadership meeting of the Senate Democrats. He asked me to express his regret that he is not here to continue to chair this hearing and ask you some questions. However, I have some of his questions so I will do my best to ask them but I can't guarantee that I will ask them as well as he would have asked his.

I do want to just clarify one thing. It was a question I asked Dave Ruder regarding the evolution of trading systems. There are different kinds of trading systems both in this country and around the world and the question is, are we going to be evolving more towards a screen-based trading system, will the floor of the New York Stock Exchange go the way of the dinosaur? What do you all see?

Let me start with Mr. Hennessy since he is physically located closest to that action.

Mr. **Hennessy**. That's a question we debate internally and among our colleagues continuously, Senator. I don't think there's any one answer.

From my own experience, I was in London at the time of big bang and the decision there was to move from a floor-based system, a central marketplace, to a basically over-the-counter market. Now at the time the London Stock Exchange made that decision, they didn't actually understand the decision they were making.

They built a fantastic floor with the most modern electronic equipment and support systems. And then, lo and behold, one month after big bang there was no one on it because they had chosen to do a screen-based telephone system. There is no reason for anyone to be on the floor of the London Stock Exchange any more.

Senator **Heinz**. That's where they should have their soccer games.

Mr. **Hennessy**. Well, there is a debate about what they should do with it.

I had the advantage of being one of the executive committee members of the London Stock Exchange during the market break. We sat around the table and talked about whether our system was better than the New York Stock Exchange system at that time, and whether we should close the system because they were closing.

We came to the conclusion that we should not close the system because on a telephone system and a screen-based system we didn't know what it meant. People would still be able to talk on the telephone—there would not necessarily be quotes on a market at which people would be willing to deal, but we thought it would cause more confusion.

My personal bias is that I prefer the New York Stock Exchange type system, the central market system. I think it has more transparency and if, as they have, you bolster the specialist system where you know there's two layers of liquidity—liquidity being provided by the players, the investment bankers, but also by the specialists—you have a system that people understand.

Nevertheless, the electronic systems around the world, the OTC, the NASDAQ seem to be gaining. I think the split in our own company is between the older folks, like myself, who like the New

York Stock Exchange, and the more modern people who deal with PCs who believe that's the wave of the future.

I think both should be allowed to compete to see which works better.

Senator HEINZ. Well, that's certainly happening.

Lord Camoys, any comments on this?

Lord CAMOYS. Yes, Mr. Chairman.

First of all, I'm glad my colleague and competitor is as broad-minded as he is.

I think that the question of whether it should be screen-based or floor-based is not the most important issue and I think a screen-based system can provide just as much liquidity as a floor-based system.

I think that in London quite clearly—and I admit this readily—we are still learning and testing the system that we installed and certainly there were imperfections in how it was first designed.

So I think that we have to wait a while before we make any—if we do make any major changes. But I think the issue is not whether a screen is used or not. I think much more the question is whether we have specialists.

Senator HEINZ. Do you agree that liquidity can be provided without specialists?

Lord CAMOYS. Yes, and I think certainly that has been proven. We came from a system in the U.K. where there in fact was very little liquidity for a lot of reasons. The new system did initially and for a long time provide much more liquidity than there was hitherto.

I must say I think it would be a brave person, Mr. Chairman, who claims that the specialist system always provided liquidity. I think there's plenty of proof that there are occasions when that liquidity hasn't been there.

Mr. AXILROD. Mr. Chairman, may I make a comment?

Senator HEINZ. By all means.

Mr. AXILROD. There's no doubt in my mind we are moving more and more toward a screen-based system. Still, there's probably a role for stock market specialists or in our U.S. government security markets for their equivalent, primary dealers. But I think it's going to be a diminishing role, with their role that of someone franchised to provide the kind of residual liquidity needed for a good functioning market.

The problem with the screen-based system and one that has to be very carefully looked at is you have to be sure who is on the other end of the transactions. If it's on an organized exchange, you have reasonable assurance. If it's over the counter, you have a little less assurance. And if it's in a broad, sort of unregulated over the counter market, you have relatively little assurance. The problem of how to manage broker screens in the U.S. government securities market involves all these questions about the ultimate role of the dealer as a market-maker and, for screen-based transactions as such, questions about guaranteeing counter-party performance.

Senator HEINZ. Since the subject of this hearing, of course, is the international aspects of this, what are the implications for international securities regulation?

Mr. AXILROD. Well, I think clearly when you get into the future 50 to 100 years from now when you can set up your 24-hour trading operation——

Senator HEINZ. Neither you nor I are terribly likely to be here 100 years from now. Just five or ten years from now, what do we need to be doing now, if anything, if you are right that the evolution is towards a more unified NASDAQ type of system not only here but elsewhere with some tie-ins.

Mr. AXILROD. I think there you really do have to get to some sort of international self-regulatory apparatus and probably governmental oversight of that self-regulatory body, having to do not only with clearance and settlement systems but also protection with respect to counterparties—who's on the other side of the screen, who's going to make deliveries if there is a fail, what in general are the obligations of the sponsor, so to speak, of the screen. If you're dealing across markets to a great extent, then it will be even more complicated to deal with those kinds of problems.

Senator HEINZ. Now Lord Camoys made an interesting point in his testimony about stock certificates and as I understand what you said, you indicate that you believe that is an important step in refining and streamlining the clearance and settlement system and that it is to be encouraged that we move toward some kind of book entry system.

As I understand it, you also said that government intervention is necessary. I'm not quite sure what you meant or why you said it. Could you elaborate?

Lord CAMOYS. Indeed I can. First of all, Mr. Chairman, I think it is critical that dematerialization comes about because that is such an important step to overcome the really highly dangerous settlement problems we saw in Europe, particularly in 1987.

The reason I said that government has to get involved is really a reflection of the—I'm ashamed to say it in some ways—the very slow progress made in my own country, the United Kingdom, where there are a lot of understandably vested interests who have been involved in providing the registration process and making a reasonable profit out of that.

The fact is that the constituent parts of the settlement system in the private sector have failed to make sufficient progress and I think this is such a critical issue that it's one of those issues where government has a responsibility to step in and force the issue.

Senator HEINZ. John, do you have any comment on dematerialization?

Mr. HENNESSY. We call it book entry. I can't pronounce that long word.

I do think you bump up against the problem that you mentioned earlier that book entry is terrific for us, but Aunt Agatha in Holt or John Jones in Denver may want a stock certificate.

Senator HEINZ. He's just not used to that PC?

Mr. HENNESSY. That's right. And the fact that he's got just a piece of paper from his broker and there's a book entry doesn't necessarily make him feel any better. However, I think it's absolutely essential and, in a sense, deplorable, that all institutional transactions around the world aren't done on a book entry basis. I think the central banks and the governments should just make a decision to do it—given where we are in the computer age, it's not much of a decision. But I do think there is a very important side effect that happens if everything goes on a book entry basis—you may just be discouraging the individual investors or driving them into the unit trust of the mutual fund, which may be inevitable anyway.

Lord **Camoys**. Mr. Chairman, I think Mr. Hennessy is being a little too cautious. I think that this is sort of a PR effort and education. I think Mr. Jones can be persuaded to accept a lesser authority from a reputable organization.

By the way, Mr. Jones from time to time loses his stock certificate anyway, which is a much more serious predicament.

Mr. **Hennessy**. Often.

Lord **Camoys**. As we know, it's a much more serious predicament than losing something that can be copied and faxed to him the next day.

Senator **Heinz**. Let me turn to EC 92. Mr. Hennessy in a sense was quite a counterpoint to some of the testimony we had yesterday from John Heimann in particular, who tended to allay our fears by virtue of the second banking directive, that EC 92 was going to be either balkanization or more restrictive.

Mr. Hennessy said—I think his testimony was rather pessimistic about EC 92. Maybe that's fear for the worst, hope for the best.

Lord Camoys, let me start with Lord Camoys, is Mr. Hennessy right? Is there a real potential for the difficulties he worries about?

Lord **Camoys**. I believe not and I hope he's wrong therefore. It has been quite a debate, however, but I believe we are moving away from the risk of fortress Europe in this regard. I think that that's partly because not only Britain would like what we propose, but also I think quite clearly the French would like to see Paris as a more important financial center, etc., etc.

There is always a danger of protectionism in its various forms and the reciprocity card is one that could be used. But no, I'm not actually persuaded by Mr. Hennessy's remarks.

Senator **Heinz**. Mr. Axilrod, any comments on this?

Mr. **Axilrod**. I certainly agree with Jack's assessment of the condition of domestic European markets.

Lord **Camoys**. That's a different point.

Mr. **Axilrod**. But it's a somewhat related point because that has to change in order to make it easier to get in there.

Secondly, I think that it's human nature when you build yourself a great big playground that you think is going to be a lot better for you that you're then going to restrict the kids from the other neighborhood for a while until you make sure that you have taken or know how to take, full advantage of that playground. Then you may let them in.

So I think there's a risk of at least a little bit of protectionism.

Senator **Heinz**. We refer to those colloquially in the trade area as transition rules.

Mr. **Axilrod**. That's right.

Senator **Heinz**. And I gather you're predicting that at least initially there will be some compromises among the Europeans at everybody else's expense and they will justify those by saying, "Don't worry, they're just temporary."

Mr. **Axilrod**. At the margin.

Senator **Heinz**. Nothing, of course, being more dangerous than a temporary trade barrier.

Lord **Camoys**. Mr. Chairman, I think that would require much more cohesion than in fact exists amongst the members of the Community. Sometimes it's disadvantageous that the Community lacks cohesion. I expect on this occasion the lack of cohesion is a good thing.

Senator **Heinz**. Then, in fact, you've agreed with Mr. Hennessy because what he said is that he sees a continuation of a variety of different kinds of national laws, barriers, regulations, whatever.

Lord **Camoys**. Mr. Chairman, I think that's a different point because I think the main point being addressed here was the second banking directive and whether that would provide for national treatment. And I think that that will happen. I think if there had been more cohesion among the owners of these fragmented markets, then there would have been a greater risk of the reciprocity card being used, but there isn't that cohesion to achieve that.

Senator **Heinz**. Let me take a step back from what's going in EC 92 or what's happening on trading floors and computer screens and all the rest, and ask Jack Hennessy what now a five or six hundred billion dollar question, which is that over the last several years the United States has been spending hundreds of billions of dollars more a year than we save or that we take in. Japan, on the other hand, has saved hundreds of billions of dollars more than it spends and they've lent their surplus to us, you might say, and as a result, Japan is the largest creditor in the world and this week's newspapers proclaimed—I think a little inaccurately—I think we beat the press by about a year or so—that we are the largest debtor in the world. If that trend continues, can U.S. financial institutions remain competitive, no matter how competent they are, against institutions in a country like Japan where people save hundreds of billions of dollars more per year than people spend. Senator D'Amato had a few words about this this morning where the average Japanese is now credited with savings in personal savings of $126,000.

Won't the world market share of Japanese financial institutions continue to grow if the U.S. remains a very large debtor and Japan remains a very large creditor?

Mr. **Hennessy**. Unquestionably. It's as clear as anything I think you can say. That will be an inevitable process.

Senator **Heinz**. If we don't get our house in order on trade and on the budget deficit, both of them, you're going out of business?

Mr. **Hennessy**. I think it will more dramatically impact on the commercial banks, but certainly the amount of activity that takes place in the United States in our business would diminish as a percentage of the world market, which we've seen anyway in the last ten years. That's precisely why we've expanded dramatically into Europe and now dramatically into the Far East—a significant portion of our business has gone offshore. We had to follow it. We have to be there. We've seen that shift in balance.

Senator **Heinz**. Let me ask Mr. Axilrod a different type question. You have obviously a great deal of experience in monetary policy analysis and the globalization of security markets appears to have reduced the responsiveness of interest rates on longer-term dollar securities to changes in monetary policy.

The Fed has been doing things short term, both in the open market operations and in terms of the discount rate, and long-term T-bonds have been like the Rock of Gibraltar.

Is that good or bad? Do you see that as a problem?

Mr. AXILROD. Well, I really don't quite believe in your premise.

Senator HEINZ. All right. Then challenge the premise. That's only fair.

Mr. AXILROD. I think the long-term interest rates in the U.S. have always been sensitive to factors outside the Fed's control, which include future expectations about price inflation and economic activity together with underlying savings and investment trends. What we've added to that mix now is a much closer relationship to foreign countries. So their attitudes and saving processes are added in.

Nonetheless, I have never really believed that, aside from short-run variations in interest rates, that the domestic U.S. long-term interest rate is going to settle in at a place very different from what is consistent with the long-run price expectations and productivity growth, whether it's open to the foreign countries to invest or not.

I think what will be affected by greater globalization is the volatility of interest rates because you have a whole other community of people who get motivated by what they see and read at somewhat different times than others. I know that's vague, but that would be my response.

Senator HEINZ. So you would say what we will refer to as fundamentals are still going to determine U.S. long-term securities interest rates and that the demand and supply in the world markets and access to everybody's markets is going to have minimal influence?

Mr. AXILROD. Yes, but that does not mean, Senator Heinz, that our domestic policies in the kind of globalized world we have and the kind of situation we now find ourselves are well within our control. We are somewhat limited now by foreign attitudes toward the U.S. as well as by our budget deficit, in what the Fed can really do in present circumstances. So there are constraints built around the Fed now basically by globalization but also by the position we have put ourselves in in relation to the rest of the world.

Senator HEINZ. I understand that. Let me wind this down by going into two other areas basically related to certain kinds of competitiveness, market access issues.

Mr. Axilrod, in your testimony you suggest there were limitations to any firms doing business in another country because of established business relationships and I guess that's one way of saying that Japanese securities firms haven't been wildly successful in their U.S. operations and I suppose the same could be said even more so about the U.S. securities firms in Japan.

But given the tremendous growth and worldwide success of Japanese financial services institutions, how would you account for the phenomena on the securities side they haven't done as well as on the banking side?

Mr. AXILROD. Well, I don't know the actual profitability of the domestic subsidiaries here of Japanese banks. Some, of course, are basically domestic operations here that have been purchased by Japanese. That's a very different sort of thing.

I think so far as the securities firms here go, they have expanded in the last three or four years into a relatively sizable operation. I think any business takes a certain amount of time to establish itself.

Secondly, the stock market crash had a rather profound effect on foreign attitudes toward U.S. markets. When you have that kind of crash here and around the rest of the world, the natural tendency is for customers to go home and play safe for a while. And that's what happened and I think that will recover gradually and the cross-border flows will enhance the profitability.

Senator HEINZ. So as a general rule, the answer is just the usual kind of start-up factors that any business in any new environment encounters and there are no restrictions of which we may not be aware that impede foreign entities from doing business in the United States of a significant nature?

Mr. AXILROD. That's rather fair. I think one would also say that there may have been a bit of over-estimation on the extent to which you could initially get into a market, and now there is a scaling down to a more practical size.

Senator HEINZ. Let me ask you, I don't know whether to ask this of Mr. Hennessy or Mr. Axilrod. I guess I'll ask it of Mr. Hennessy.

In recent years, there are a number of foreign firms, including U.S. securities firms, that have been licensed to do business in Japan. And they have had some difficulty making significant inroads. It's been suggested that one of the factors is a reluctance on the part of the Japanese to eliminate fixed brokerage commissions and thereby, were they to do that as we did in 1975 and as the U.K. did in 1986, at least you could get your foot in the door by competing on the basis of price.

That's not currently available and you note in your testimony the profit opportunity for firms in Japan is different from that in Europe and the United States largely because of those fixed commissions. I understand there are some other practices that are little different, too, which you did not allude to.

But you also state that you're satisfied with your firm's performance in large part because of the generous fixed commissions. Is the system buying you guys off? Aren't fixed commissions in principle a problem for American firms trying to do business in Japan? Shouldn't we really be encouraging the Japanese to eliminate fixed commissions so that we have an opportunity to enter and be competitive?

Mr. HENNESSY. I think if you're inside a club it's always better than being outside a club. And while the fixed commission is fixed in the Japanese sense, there is some erosion and some ability for those of us who are inside to be competitive—not only in the securities services we offer, but also on prices and special services such as providing research, etc.

But I noted in just this week's Business Week a report on pre-tax profits pre-tax of the U.S. firms operating in Japan. For the top four firms, in which we were listed, the total pre-tax profit for the six months ending March 31st was $80 million. The next four U.S. firms lost $10 million. So in a sense it's been better than we thought. I think foreign firms are four or five percent of the stock exchange. Although I don't know the numbers that Mr. Axilrod referred to, I know that if you added all of the securities houses' earnings together in the U.S. market you wouldn't get pre-tax earnings of $10 million, but you probably would get a big red number. So there are many restrictive practices still in Japan. There are limits to who among the firms can join the stock exchange, but I think they are moving in the right direction.

Senator **HEINZ**. What direction is that?

Mr. **HENNESSY**. They are letting more people on the stock exchange, letting more people come in and compete. But, as we have done in trade, we must keep the pressure on because while there are no restrictions here I would say, there they still exist. For those who are inside the club it's terrific, but for those who are not, it's not as good.

Senator **HEINZ**. In terms of the ability to underwrite Japanese government securities, I understand that that is a bid process, at least nominally. Is that correct?

Mr. **HENNESSY**. It is a bid process, but again there is an "old boys" network, as in so many of these things.

Senator **HEINZ**. Now I am told that if you bid an eighth of a point below Nikko, Namura, Daiwo and all the rest, and you put in the bid for 15 or 20 percent of the offering, that even if your bid is an eighth of a point below that, that you're not going to get it. Is that true?

Mr. **HENNESSY**. I don't know factually whether that's true, to be honest. I do know there is a different system of allocating government bonds than the Dutch auction system we use in the United States. We have not been large players in that marketplace simply because in order to buy one percent or ten percent you have to have a demand for yen bonds. Frankly, we have not seen among our worldwide customer base, including within Japan, a huge demand for those. There are some other foreign firms who have been larger players than us. We do play to a certain extent. We don't find it a great frustration.

I think when and if we found a huge demand for yen around the world, we would be concerned. I do think that the system should be clarified and put on the same basis as the U.S. system.

Senator **HEINZ**. Mr. Axilrod, is it true that there's basically an allocation system followed by the Japanese government and the insiders on Japanese government securities?

Mr. **AXILROD**. Well, as you know, on this ten-year bond——

Senator **HEINZ**. No, I don't know. That's why I'm asking.

Mr. **AXILROD**. The ten-year bond, which is a key bond—the bulk of the rest of the government bonds are auctioned—is 60 percent syndicated and 40 percent auctioned. On the syndicate, which is a a huge syndicate, including small and large Japanese firms, the foreign firms now get about 8 percent of the allocation, which I think is roughly consistent with or maybe somewhat larger than their volume of transactions.

Senator **HEINZ**. What about the bid part?

Mr. AXILROD. On the bid part, there have been three auctions. It was reported in the Japanese press and I put it in my statement that an American firm got the largest allocation in the 40 percent part that's bid in the latest auction.

Senator HEINZ. Do you know who that was and how much it was?

Mr. AXILROD. Well, I think I do, but I don't feel at liberty to say it.

Senator HEINZ. Without naming names, do you know how much it was?

Mr. AXILROD. I think they got the full potential 30 percent. I think that was reported.

Senator HEINZ. Interesting, if true.

Mr. AXILROD. I think it is right. The largest Japanese house got the bulk of the auction at really too high a price for the market in the first two auctions, and in the third auction an American firm got the bulk. So I think it's a perfectly straightforward auction.

Senator HEINZ. It would be unique in Japan if that was true.

Mr. AXILROD. I don't think so in any true auction process.

Senator HEINZ. The construction industry is supposed to be done on some kind of bid basis and I trust you know the basis on which it's done in Japan. Well, it's probably just as well that you don't.

Lord Camoys, let me ask you about some very important observations that you've made which I would just repeat to refresh everyone's memory.

You note the importance of coordination within borders as well as across borders and you underscore the importance of the domestic coordination by noting that tax policy often dramatically affects business international competitiveness but that tax policy experts have other things in mind at times and suffer from a lack of experience in global and local securities markets. I think I quote your testimony. And that this can lead to uncertainties in the marketplace.

How has the coordination of policy in the U.K. been addressed and is your country a good model or a bad model? If it's a good model, should we consider it?

Lord CAMOYS. Senator, I'm not sure whether you're referring to tax matters.

Senator HEINZ. Yes. Tax matters as a specific subset.

Lord CAMOYS. I don't think the history is perfect at all, but I think that there is considerable consultation on a confidential basis before, for instance, the Finance Act is drafted. It's done on a privileged basis whereby the Treasury officials go to a body which represents those parts of the community that are likely to be affected and very often, therefore, some of the mistakes that could happen are avoided. But it's not perfect.

I think the problem will never go away totally because those who are responsible for tax matters in our country have never had any experience in the private sector. So there is a problem, but what it requires is consultation prior to the event of a change rather than afterwards.

Senator HEINZ. Very well. Do you have any comments on what the U.S. Congress ought definitely to do or not do? But keep your comments brief.

Mr. AXILROD. I have one.

Senator HEINZ. We will of course balance the budget.

Mr. AXILROD. In the securities market area, by the way, I don't know whether you need to do it legislatively or not, but I do think when you get into international negotiations, as you will inevitably on securities market regulation, we really ought to have the financial futures markets and the cash markets together and thought of pretty much in a unified way in the process of those negotiations.

Senator HEINZ. A well taken point. Jack.

Mr. HENNESSY. I would support that wholly and I think Lord Camoys is also nodding his head.

There's just one point which we didn't touch on.

Senator HEINZ. On that point though, are you satisfied with the description that Dave Ruder gave of his progress in implementing the nine key recommendations proposed by the Group of Thirty?

Mr. HENNESSY. On the last three I doubt whether they're there, and I doubt whether this idea of cooperation between cash and futures is really substantive.

I have just one point, which is, this committee and others have expressed concern over foreign direct investment acquisitions in the United States. I am a great believer in the free flow of capital. I think it benefits everyone. But I do think increasingly that this body, as part of 1992 and other deliberations, will have to look at the question of restrictions on capital ownership and on the domestic practices of takeovers.

I think that national treatment——

Senator HEINZ. If you're saying it's a lot harder to take over firms in other countries than it is here, that's certainly true in the EC.

Mr. HENNESSY. The U.K. is more like the U.S.

Senator HEINZ. They say they've got a wonderful gauntlet that you run. First, in Britain you go to the board and it says yes or no. If they should say yes, you now get to go to Brussels and Brussels can say no. If, however, people in the U.K. say no, Brussels can't reverse that. So you've got two chances to lose and at best one chance to win.

Mr. HENNESSY. With due respect, I think the Anglo-Saxons think about this more or less the same and they have a lot of hostile takeovers, and I think they're basically all right. The problem is on the continent which has no history of hostile takeovers. There's never been a hostile takeover in Germany. In Brussels we saw it happen to——

Senator HEINZ. The continent stretches all the way to the Pacific Rim I think.

Mr. HENNESSY. Yes, except for Australia. Australia, again has a different history and they do permit it. So I think increasingly people will begin to ask these questions. I think that the right principle to follow is national treatment, foreigners should be afforded the same treatment as domestic firms in takeovers. And I think other countries should be encouraged to have much more open ownership and less restrictive practices in the area of takeovers. It's coming by market forces because of EC 92, but it's coming very slowly.

Senator HEINZ. National treatment is in most societies a meaningful concept and a good principle. I would question whether in Japan national treatment has the same meaning as it does in other countries because the Japanese don't treat all Japanese alike. If you are a member of "the club" you are in good shape. If you are not, you are out of it. So in Japan, national treatment is we discriminate against some people and we don't against others.

Lord CAMOYS. Senator, there's one very good exception or example to that and that is in terms of Article 65, the equivalent of Glass-Steagall. Japan actually has been far more accommodating in that regard so far as foreign banks are concerned than your own country.

Senator HEINZ. I can't resist since Mr. Axilrod is here. Mr. Axilrod, do you support Boone Pickens' efforts to gain at least some say in the company, Tokyo, in which he owns such a substantial part or should he just be a passive investor who knows that he should keep his mouth shut and stop making trouble?

Mr. AXILROD. Well, Senator Heinz, I have great reservations about some aspects of corporate restructuring. I said LBO, but obviously misspoke since that's not the specific nature of the transaction here and whether it's constructively contributing to our own economy. So naturally I would have some reservations about that in general around the world. I'm not against acquisition-type transactions obviously of a sound sort and I think that's the most relevant comment I can make in a practical way.

Senator HEINZ. It was vague, tactful as well. So I can't—we engage in that once in a while ourselves.

Yes, Mr. Hennessy.

Mr. HENNESSY. I think that's the great case where Dainippon can do a hostile takeover of Reichhold Chemicals here, but Boone can't get 10 percent or 20 percent and sit on the board. I don't think that has anything to do with LBO's.

Senator HEINZ. It's called shareholder representation. That's why I said what I said to Mr. Axilrod.

Mr. HENNESSY. I think it's rather indefensible myself.

Senator HEINZ. LBO wasn't a good word for it.

I think obviously it's indefensible and the question is what should we do about it. And the answer that I would give you really resided at least temporarily in the Senate version of the 1988 trade bill which said national treatment in financial markets is a very good principle, but if you don't get national treatment we reserve the right to withdraw national treatment from you.

Well, gentlemen, you've been an expert set of witnesses. I thank you very much for your fine testimony. We appreciate your attendance. Thank you very much.

The hearing is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

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Memorandum June 7, 1989

TO : Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Committee on Banking, Housing, and Urban Affairs

FROM : Kevin F. Winch
Specialist in Industry Economics
Economics Division

SUBJECT : Globalization of Securities Markets

On May 26, 1989 you asked CRS to provide descriptive material on global financial markets and the institutions and individuals participating in those markets to assist the Securities Subcommittee in hearings scheduled for June 14 and June 15 on globalization of the securities markets.

In response, CRS prepared the attached report, *Globalization of Securities Markets*. The report was prepared by the following Economics Division personnel: Kevin F. Winch, Specialist in Industry Economics; Edward Knight, Specialist in Industrial Organization and Corporation Finance; and Mark Jickling, Library Technician.

We hope that the report is useful to the Subcommittee in its deliberations.

Globalization of Securities Markets

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June 7, 1989

ABSTRACT

This report explores trends in international securities markets, noting both trading activity in outstanding securities and volume measures of newly issued securities. Special attention is paid to the world's major trading markets in New York, Tokyo, and London. Additional material covers the new issue markets, futures markets, international swap markets, and foreign transactions in U.S. securities.

GLOBALIZATION OF SECURITIES MARKETS

SUMMARY

International traffic in financial instruments is far from new. What is new – a phenomenon of the 1980s – is the rapid growth in global financial transactions. This growth has been sparked by rapid technological advances in communications and data processing systems in combination with deregulatory activity in many national financial markets.

Points of interest include (1) for the first time, in 1988 volume on the Tokyo Stock Exchange exceeded volume on the New York Stock Exchange; (2) the structure of equity ownership in the three major markets exhibits major differences, with individual ownership predominant in New York, but playing a relatively minor role in Tokyo; (3) bond issues rather than bank loans are now the preferred channel for raising funds in international capital markets; and (4) on a gross basis, in the United States new corporate equity issues raise modest amounts of capital, but after netting out deductions due primarily to corporate reorganizations, the equity markets represent a net outflow of capital.

Financial futures markets are also growing rapidly; they offer an alternative trading medium for securities market participants. U.S. exchanges continue to dominate futures market activity. Another rapidly growing way to exchange financial risk is through the international swap market: since its start in 1982, this market has grown in size to over $1 trillion. Foreign transactions in U.S. securities – both Government and corporate – have increased rapidly in recent years.

While the authors are reasonably confident that the data reflect marketplace trends, readers should not rely on the statistics presented here for exactitude. Anomalies in the data can arise from exchange rate conversion procedures, from different national reporting and measuring standards, and from methodological quirks employed by reporting organizations which systematically organize data from different markets to present global totals.

TABLE OF CONTENTS

GLOBAL SECURITIES MARKETS 1

EQUITIES: THE GLOBAL SETTING 3
  MAJOR EQUITY MARKETS: NEW YORK, TOKYO, AND LONDON 4
  TRADING IN INTERNATIONAL EQUITIES 6
  SHARE OWNERSHIP 7

NEW ISSUES MARKET 11
  INTERNATIONAL NEW ISSUES 11
    Funds Raised By Type of Instrument 13
      International Bonds 14
      Foreign Bonds 14
      International Bank Loans 14
      Foreign Bank Loans 15
      Other International Facilities 15
    Funds Raised By Borrowers 16
  DOMESTIC NEW ISSUES 17
    U.S. New Issues 17
      Gross New Issues 17
      Net New Issues 19
    U.K. New Issues 21
    Japanese New Issues 22

FUTURES MARKETS 22

INTERNATIONAL SWAP MARKET 24

FOREIGN TRANSACTIONS IN U.S. SECURITIES 27

APPENDIX A: SUPPLEMENTARY DATA 32
  TABLE A-1. Top Global Underwriters of Debt and Equity 32
  TABLE A-2. Top Underwriters of U.S. Debt and Equity 33
  TABLE A-3. Top International Underwriters 34
  TABLE A-4. Top 40 Commercial Banks, 1987 35

APPENDIX B: GLOSSARY 37

John Williamson provided production assistance in the assembling of this report.

TABLES

1. Tokyo, New York, and London Stock Exchanges: Selected Statistics for 1986-1988 5
2. Number of International Equities by Home-Base Country of Issuing Corporation, 1984-1987 7
3. U.S. Private Sector Capital 18
4. Newly Issued Corporate Bonds 20

CHARTS

Worldwide Securities: All Listed Securities 2
Major Exchanges: Trading Volume 6
United States: Ownership of Shares 8
United Kingdom: Ownership of Shares 9
Japan: Ownership of Shares 10
International Markets: Funds Raised by Instrument 13
International Markets: Funds Raised by Borrower 16
Gross New Issues: U.S. 18
Net New Equity 19
Gross New Issues: U.K. 21
Gross New Issues: Japan 22
Futures and Options: Global Trading Volume 23
Foreign Transactions in U.S. Securities, 1980-1988: All Countries 28
Foreign Transactions in U.S. Securities, 1980-1988: Japan 29
Foreign Transactions in U.S. Securities, 1980-1988: United Kingdom . . 30
Foreign Transactions in U.S. Securities, 1988 31

GLOBALIZATION OF SECURITIES MARKETS

This report explores trends in international securities markets, noting both trading activity in outstanding securities and volume measures of newly issued securities. Special attention is paid to the world's major trading markets in New York, Tokyo, and London. Additional material covers the new issue markets, futures markets, international swap markets, and foreign transactions in U.S. securities.

While the authors are reasonably confident that the data series included in this report reflect marketplace trends, readers should not rely on the statistics presented here for exactitude. Anomalies in the data can arise from differences in exchange rate conversion procedures, in national reporting and measuring standards, and from methodological quirks employed by various reporting organizations which organize data from different markets to present global totals.

The report is descriptive rather than analytic in purpose and nature: policy questions are not addressed. Rather, the data presented in tables and charts offers a perspective on the relative size of the markets involved, the kinds of securities most frequently traded, and profiles of the participants in various markets.

GLOBAL SECURITIES MARKETS

If the value of all the securities, and security-like financial instruments, everywhere in the world were totaled up, what would be the sum? That answer is not available, but there is little doubt that the amount would be very large. A *minimum* base upon which to build such estimates is presented in the accompanying chart which shows the share of the three major exchanges – the New York Stock Exchange (NYSE), the Tokyo Stock Exchange (TSE), and London's International Stock Exchange – in the value of all listed bonds and debentures (debt securities) and all listed shares (equity securities) on all the world's exchanges. The worldwide total amounts involved include $6.380 trillion in bonds and $12.898 trillion in stock; when the three major exchanges are taken together, they account for slightly more than fifty percent of this global total.[1]

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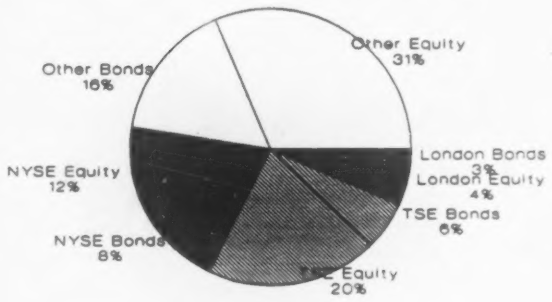
[1] Federation Internationale des Bourses de Valeurs. *Activities and Statistics, 1988 Report*. p. 19, 23.

WORLDWIDE SECURITIES
All Listed Securities

$19.3 trillion - December 31, 1988



Source: F.I.B.V. 1989

In general, this part of the report deals with the securities markets routinely reported in the daily media – *secondary* markets such as the various stock exchanges. In secondary markets, ownership of securities shifts as funds change hands among investors, but the government or corporation which originally issued the securities is not usually a participant in the trading and is neither benefitted nor harmed directly by market movements. However, an issuing corporation, for example, will be interested in the (secondary) market price of its stock as a guide to its cost of capital should it decide to raise additional funds in the stock market through a new primary offering of shares.

There are two significant considerations which limit the significance of the above data when the concern is global, or worldwide trading, as opposed to domestic or national trading. The first and clearest constraint is that most of these securities trade only in domestic markets and are not a factor in cross-border trading. The second limitation is that the data are incomplete (but the securities data which are incomplete are the least likely to be part of international trading).

Based only on information available for the U.S. securities markets, it is clear that the data shown above are incomplete, primarily because they are restricted to the value of securities listed on organized exchanges. For example, the market value of unlisted securities traded through NASDAQ, the automated quotation system of the National Association of Securities Dealers, amounted to $350.5 billion at the close of 1988.[2] Finally, many corporate securities are private placements, and are never listed on trading exchanges. In addition, many corporate bonds are purchased by institutional investors such as insurance companies to match anticipated actuarial liabilities and are never traded.

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[2] National Association of Securities Dealers. *Fact Book 89*. Washington, National Association of Securities Dealers, 1989. p. 12. The total includes $0.5 billion in debentures, and about $3 billion in other non-equity securities.

The size of global securities markets is probably a multiple of the approximately $20 trillion identified above. In addition, securities markets totals do not include information on trading in futures and swaps, two increasingly important international financial trading activities. Material dealing with the growing markets in derivative financial instruments, that is, in futures and options trading, both in the United States and in other markets is considered briefly in this report. Information on the swap market, where risk exposure for both currency exchange rate and interest rate changes are traded is also considered briefly in the report.

EQUITIES: THE GLOBAL SETTING

Since the early 1980s, there has been a marked growth in the international trading of equities. Equities are defined as common or preferred stocks issued by corporations to raise capital. They represent an ownership interest in a corporation by investors who purchase such stocks.

Though trading of equities across national boundaries has been going on for some time, such activity has mushroomed in recent years and is likely to continue to grow impressively in the future.

Much of the globalization has resulted from the increasing linking together of the world's there major trading centers: New York, Tokyo, and London.

Major forces revolutionizing the patterns of equity trading, which until recent years was primarily confined to domestic markets, have been:

- Rapid technological advances in communications and data processing systems, which are greatly facilitating the international trading and linking of equities markets;

- Government deregulation in many areas of financial activity at home and abroad, which has served to (1) increase competition in world financial markets, and (2) open up domestic markets to foreign investors — particularly in the case of the London and Tokyo markets;

- Increasing tendency of many institutional investors, primarily mutual funds and pension funds, to diversify their investments on a global basis;

- Growing inclination of U.S.- and foreign-based firms to rely on foreign debt and equity markets to raise capital;

- Growing economic interdependence between the United States and its major trading partners, as evidenced by marked increases in foreign trade and investment at home and abroad.

If global trading in equities continues at its recent pace, it will transform the structure and operations of equities markets at home and abroad in the future. Policymakers, especially in the United States, have expressed interest in knowing how this changing pattern of trading might affect the soundness of financial markets domestically and internationally and the effectiveness of regulators in safeguarding the integrity of securities being traded in the global market place.

MAJOR EQUITY MARKETS: NEW YORK, TOKYO, AND LONDON

In reviewing numerous sources, there appears to be a widespread consensus among students of equity markets: first, that most of the global trading in equities will be centered in three markets – New York, London, and Tokyo; and, second, as time goes on these markets will become increasing linked and integrated with one another.

Table 1 below contains selected data which provide some rough approximations of relative market size and trading activity in each of these major market centers.

Among the three markets, London has by far the largest number of firms listed on its exchange. It is the leader in terms of both domestic and foreign companies listed. The totals given for New York and Tokyo exchanges are in the same range, with Tokyo having considerably more foreign firms listed.

In 1986 and 1987, all three markets experienced considerable growth in trading volume (in dollar terms). However, in 1988 both the New York and London exchanges experienced sizeable drops in volume. At the same time, Tokyo experienced continued gains. It should be noted, however, that there was a marked appreciation in the yen relative to the dollar after 1986. Had there been no such appreciation, and had all other factors remained constant, the total volume of trading on the Tokyo exchange would have been $1.76 trillion (the same level as that recorded in 1987) instead of the $2.23 trillion total shown in table 1. Nonetheless, even with this adjustment, Tokyo's volume far exceeded that of New York's in 1988. Consequently, for the first time in its history, Tokyo is now the number one trading center in the World in terms of trading volume.

TABLE 1. Tokyo, New York, and London Stock Exchanges: Selected Statistics for 1986-1988

	Number of Listed Companies			Volume of Trading[a]	Total Market Value of Equity Shares of Domestic Companies Listed[b]
	Total	Domestic	Foreign	(in $ billions)	
Tokyo					
1988:	1,683	1,571	112	$2,234	$3,789
1987:	1,620	1,532	88	1,757	2,726
1986:	1,511	1,499	52	955	1,794
New York					
1988:	1,681	1,604	77	1,356	2,366
1987:	1,647	1,580	67	1,889	2,132
1986:	1,575	1,512	63	1,389	2,128
London:					
1988:	2,580	1,993	587	361	712
1987:	2,658	2,061	597	517	679
1986:	2,685	2,101	584	113	472

[a] Annual average.

[b] As of December 31.

Source: Federation Internationale Des Bourses De Valeurs. [F.I.B.V.] *1987 Report*. Paris, France, 1988. p. 16, 17, and 19; [F.I.B.V.] *1988 Report*. Paris, France, 1989. p. 16, 17, and 19.

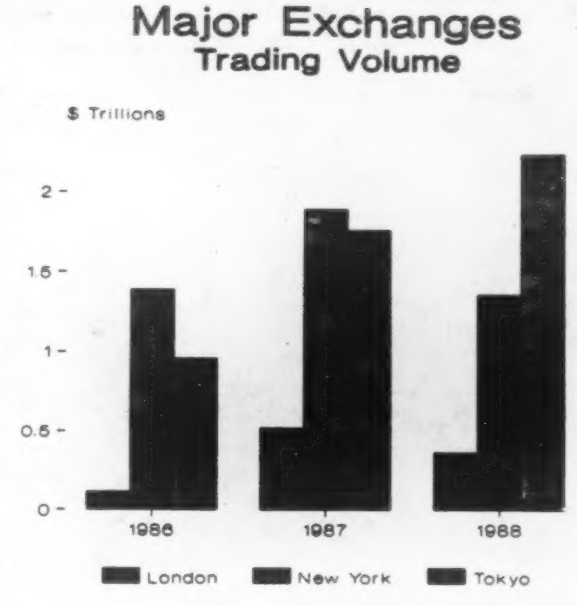
The table also shows that the total market value of equity shares (i.e., capitalization) of domestic companies listed on the various exchanges is considerably higher on the Tokyo exchange than that recorded on the New York and London exchanges. Until 1986, New York was clearly the world leader in terms to total capitalization. However, beginning with 1987, the Tokyo exchange, for the first time in its history, began to move ahead of New York.

These figures on capitalization for the Tokyo market, for comparative purposes, are considerably overstated. This is because only about 30 to 35 percent of the shares outstanding are actively traded on the exchange (i.e., "free floating"). As noted in one recent study:

> Huge cross-holdings actually make the market look large due to a sort of double counting. The bulk of shares is held in implicitly long term accounts by major banks and insurance companies. They hold shares in client companies more as a sign of support and for the purpose

of maintaining amicable business relations than anything else.[3]

Consequently, when adjustment is made for these cross-holdings, the real size of the market for freely traded stocks ranged somewhere between $1.14 trillion and. $l.33 trillion — levels considerably below the $3.79 trillion cited in table 1 for 1988. Assuming that a much larger proportion of outstanding shares are freely traded on the New York exchange, it is likely that the New York market in terms of capitalization is still larger than the Tokyo market.



Source: F.I.B.V.

In sum, it is apparent that the Tokyo market is posing a stiffer competitive challenge to the New York market with every passing year. Whether it has replaced New York as the number one trading center in the World is difficult to discern with any degree of accuracy at this point.

TRADING IN INTERNATIONAL EQUITIES

As seen in table 2, some 487 stocks, according to a survey by *Euromoney* magazine (May 1987), were being traded internationally in 1987. These international equities are generally defined as stocks having an active and liquid market in at least one trading center outside of the home country of the issuing firm. This represents a considerable increase over the 236 such equities traded in 1984. In rank order, the countries with the largest number of firms whose equities trade internationally are the United States, Japan, United Kingdom, Australia, and Canada. Firms based in these countries accounted for 60 percent of the equities being traded in 1987.

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[3] *Report of the Presidential Task Force on Market Mechanisms*. Washington, U.S. Govt. Print. Off., January 1988. P. I-11. For further discussion, see: U.S. Library of Congress. Congressional Research Service. *The Stock Market in Japan: An Overview and Analysis*. Report No. 89-306 E, by Arturo Wiener an Edward Knight. Washington, 1989. p. 7-13, 17-19.

TABLE 2. Number of International Equities[a]
by Home-Base Country of Issuing Corporation
1984-1987

	1984	1985	1986	1987
TOTAL	236	328	493	487
United States	84	85	90	82
Japan	49	65	75	73
Australia	16	25	34	49
United Kingdom	13	25	45	49
West Germany	7	22	27	30
Canada	12	15	39	40
Netherlands	7	13	21	19
Hong Kong	5	11	14	13
France	1	11	24	26
Sweden	10	10	16	17
South Africa	7	10	16	15
Italy	2	9	13	11
Switzerland	5	9	20	25
All Other[b]	8	18	59	38

[a] Stock having an active and liquid market in at least one center outside of home base of its corporate issuer.

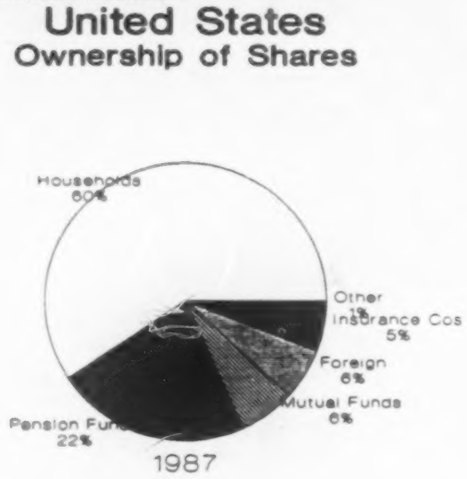
[b] Includes Belgium, Finland, New Zealand, Denmark, Norway, Singapore, and Malaysia for 1984-1987, and Spain and Mexico for 1985-1986 only, Philippines for 1987 only.

Source: *Euromoney*, May 1985, May 1986, May 1987, and May 1988.

SHARE OWNERSHIP

CRS has provided relative share ownership charts for the most recent data it has available for the U.S., the U.K. and the Tokyo markets. Since security trading is traditionally anonymous – traders rely on the exchanges rather than a counterparty for clearing and settlement – data identifying owners of shares is not compiled as a function of trading. Often, sample surveys are used to estimate ownership, and in the case of the United States, the Federal Reserve provides estimates in its periodic flow of funds calculations.

Different types of owners tend to follow different patterns of investment so that the composition of share ownership can matter a great deal to the functioning of the market. In 1987, households in the United States owned about 60 percent of all corporate equities, with the total of all equities valued at $2.85 trillion; in 1964, when the value of all equities was $633 billion, households owned 85 percent of corporate stock.[4] The shift in ownership – primarily to institutional investors such as pension funds, insurance companies, and mutual funds – has led to more active trading, trading in larger units (e.g., block trades of 1,000 shares or more for institutions versus round lots of 100 shares for individuals), and a more volatile market.[5]



Source: Federal Reserve Flow of Funds

As a general rule, block trades on the New York Stock Exchange (NYSE) are transacted off the exchange floor so that investors monitoring trading activity become aware of market interest in large numbers of shares only after the transaction is complete. One analyst, after noting that "it has become commonplace for economists to refer to the stock market as a real world example of a perfectly competitive market," summarizes the result of the increase in block trading on the NYSE:

> The result is that the most commonly cited real world example of perfect competition is a market in which over half of the market trades are at prices determined by a handful of large brokers, banks and institutions outside the official market mechanisms of the [New York Stock] Exchange floor. Despite the increasingly widespread ownership of stocks, the majority of trades normally do exert direct influence on price.[6]

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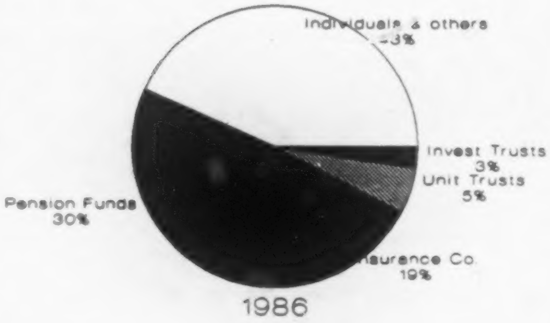
[4] Data on share ownership is taken from Board of Governors of the Federal Reserve System. *Flow of Funds Account; Financial Assets and Liabilities; Year-End, 1964-87*. Release Z.1, September 1988, Flow of Funds Outstandings, 1964-87. p. 43-44.

[5] In terms of value, the largest block trade on record occurred on June 1, 1989, when Carl Icahn sold 42.3 million shares of Texaco stock for $2.1 billion. See Mufson, Steve. Icahn Sells Big Stake in Texaco. *Washington Post*, June 2, 1989. p. F1, F4; and Wallace, Anise C. Strong Market Is Unfazed as Texaco Stock Is Resold. *New York Times*, June 3, 1989. p. 35, 38.

[6] Kregel, J.A. Financial Innovation and the Organisation of Stock Market Trading. *Banca Nazionale del Lavoro Quarterly Review*, No. 167, December 1988. p. 376.

The information available at this time to CRS regarding share ownership of securities traded on London's International Stock Exchange (ISE) is somewhat limited. By using reported data for "major institutional holdings" at the end of 1986 of £181.6 billion and the total market value of all listed securities at the end of 1986 of £320.7 billion, a residual value was calculated for "individuals and others."[7] The disadvantage of this approach is that potentially significant information, e.g., the participation of foreigners in the London market, is lumped together with individual holdings.

United Kingdom
Ownership of Shares



Source: International Stock Exchange

Separately, the ISE estimated that shareholdings in the "personal sector" (equivalent to the household sector in the United States) amounted to £140.7 billion at the end of the third quarter 1987.[8] This figure is roughly comparable to the £139 billion estimated by CRS for the end of 1986. Using data from a February 1988 survey, the ISE estimates that there are nine million individual shareholders in the U.K. or 20 percent of the adult population, compared to three million or 7 percent al all adults in 1979. In 1987, individuals – also known as "private clients" – accounted for 74.4 percent of all ISE transactions, but only 21.6 percent of the value of all transactions.[9]

To a large extent, the growth of individual stock ownership is the direct result of offerings associated with the U.K. government's privatization of state owned industry. According to the ISE study,

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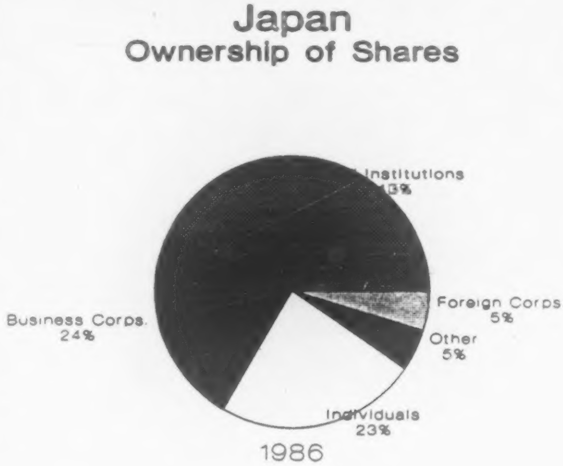
[7] All share ownership data for the London market are from Appendix 3, Major Institutional Holdings. *Quality of Markets Quarterly*, Spring 1988. p. 66. (This periodical is published in London by The International Stock Exchange of the United Kingdom and the Republic of Ireland Limited.)

[8] Private Investors and Services. *Quality of Markets Quarterly*, Spring 1988. p. 22.

[9] Ibid., p. 24.

> While the number of individual shareholders has increased dramatically as a result of the Government's wider shareownership campaign, virtually all the new six million shareholders have very small holdings. . . . Most of these new shareholders are not clients of [stock exchange] member firms, having acquired their shares through direct application for privatisation issues. In fact, only 17% of current private shareholders acquired shares via a broker, bank or share shop.[10]



Source. Tokyo Stock Exchange

Share ownership in Japan is markedly different than the patterns seen in the U.S. and U.K. markets. Data provided by the Tokyo Stock Exchange (TSE) for 1986 are *not* based on the total value of equity securities, but on ownership of the *number* of shares; thus the base for calculating relative shares in 1986 is 330.596 billion shares issued by 1,882 companies. Particularly noticeable on the chart is the cross-ownership of stock between business firms which has already been mentioned in this CRS report. Another major difference between the Japanese data and data for the United States and the United Kingdom is the relatively modest 23 percent share of the total accounted for by individual ownership. The "other" category includes share ownership by securities companies, investment trusts, and central and local government holdings.

Assumptions based on U.S. trading markets are generally inappropriate in Japan. Industrialist and investor T. Boone Pickens recently purchased a 20 percent share of Koito Manufacturing Co., a supplier of automobile lighting. Pickens refers to his opportunity to purchase a major block of Koito shares as "unique"; not much of the stock is available for purchase.

> In a typical Japanese public company, 60 to 80 percent of its shares are held by what is known as a *kiretsu*—a web of "stable" stockholders, most of whom either do business directly with the company or with one of the company's major holders. Koito is a classic case. Toyota Motor Corp. owns 19 percent of Koito's shares—and at the same time

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[10] Ibid., p. 23.

> is Koito's largest customer, buying almost half of its products. Another 40 percent is held by Koito's other customers, banks, insurance companies and suppliers. These stockholders do not expect to make money through the stock, but through the business relationships that come with being a member of the club.[11]

Pickens described frustrating delays involved in registering ownership, meeting management and getting representation on the company's board; he also notes that the accommodation of Japanese investors in the United States has been much more generous than was his treatment as an investor in Japan. From the Pickens' perspective, "What makes this problem so tough to deal with is that the most powerful impediments are not legal restrictions but silent barriers produced by nationalistic custom and practice."[12]

NEW ISSUES MARKET

The new issues market is the starting point for studying the relationship between borrowers and lenders in the financial markets. In the final accounting, governments, corporations and other entities need funding to adapt to changing conditions, to adopt improved techniques, and generally to survive and to grow. Financial markets throughout the world are partway through a process of change driven by technological changes, deregulatory initiatives, and market changes. In the midst of all this change, it is of interest to study what has been happening in the traditional markets for corporate finance.

The data are necessarily inconsistent since they were originally gathered by diverse private and public institutions, using different methods and with different aims in mind. The material is presented in two mutually exclusive categories, international new issues and domestic new issues. Equity issues are *not* reported in the international new issues series, presumably because these issues are almost exclusively domestic.

INTERNATIONAL NEW ISSUES

The international bond markets suffered a major setback in 1987, ending a strong expansion phase that began around 1980; at about the same time, there appeared to be a drop in the relative share of new U.S. bonds sold overseas. Thus, there is an apparent relative loss of U.S. participation in the international new issue market. This appearance is distorted, however. The dollar is the standard currency used in compiling these statistics, and with the turmoil in currency markets in 1987, there was a sharp decline in the value of the dollar.[13] Nevertheless, changing market conditions, including a persistent lack of confidence in the dollar and changes in interest rate differentials, contributed to market volatility and continued to have a major impact on the pattern of international issuing activity.

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[11] Pickens, T. Boone. T. Boone Takes On Tokyo. *Washington Post*, June 4, 1989. p. B4.

[12] Ibid.

While exchange rate considerations and differences in interest rates in different markets no doubt dominate borrowers' decisions regarding which market to use, there is generally closer harmony of rates between these markets now than was true before the 1980s. Yet, other things being equal, U.S. borrowers, as well as borrowers of other nations may prefer U.S. markets because there are relative transaction cost advantages in this country.

> . . . the cost of bond issuance in the U.S. is lower than in any other country, reflecting competition, the absence of minimum brokerage fees, and economies of scale. This is true even for small issues, where the inherent advantage of large U.S. capital markets is less. Moreover, costs for securities underwriting and trading domestically are held down by competition from foreign financial centres such as London and Tokyo.[14]

Data provided by the Organization for Economic Cooperation and Development (OECD) offer a very inclusive view of international financial markets, including bank loans as well as security issues in their calculations. However, they do not report new international equity issues, presumably because such securities are negligible to bond issues and bank loans. The OECD has sorted out the new issues in international markets from two separate points of view; it shows the funds raised on international markets both by type of instrument, and separately by borrower. The two charts in this section of the report show the same data totals from 1982 to 1988, first by the type of instruments used and then by the borrowers.

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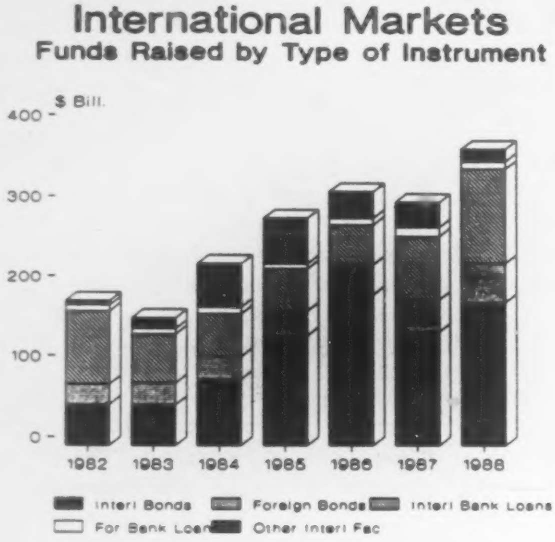
[13] When calculated on a constant exchange-rate basis, total new bond issues in international markets declined more severely than the current dollar value estimates indicate. See International and Foreign Bond Markets. *Financial Market Trends*, no. 39, Feb. 1988. Paris, Organisation for Economic Co-operation and Development, 1988. p. 59.

[14] Organisation for Economic Co-operation and Development. *OECD Economic Surveys: United States*. Paris, OECD, 1988. p. 97. The cost of a bond issue in the United States, as a percent of the total issue, ranges from 0.98 percent for a large issue to 1.45 percent for a small issue; comparable data for Belgium, the most expensive country, are 4.2 percent for a small issue and 4.10 percent for a large issue.

Funds Raised By Type of Instrument



International Markets

Funds Raised by Type of Instrument

Source OECD Financial Statistics Monthly

At the beginning of the 1980s, bank lending in one form or another was a far more important source of international funds than was bond issuance, but by end of 1988, a trend was in place which clearly reversed that relationship, making bonds the preferred source of funds. Within categories, international bonds continue to outweigh foreign bonds, and international bank loans remain more significant than other types of bank loans. These different categories may be a source of puzzlement — an "international bond" may be more familiar to some if it is called a "eurobond" — and to insure that the underlying definitions are clearly understood, the definitions as published by the OECD are included here.[15]

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[15] The definitions are in *OECD Financial Statistics, Methodological Supplement, 1987*. Paris, Organisation for Economic Co-Operation and Development, 1987. p. 11-14. Minor editorial adjustments to fit the context have been introduced. The OECD has published a long list of caveats which should be consulted by anyone wishing to compare these data with other published international financial data. The OECD notes that securities are shown at their nominal value, except when they have been issued at a discount over 5 percent to par, in which case the actual amount paid in by investors is shown. The conversion into United States dollars is made on the basis of the average spot rate for the month; monthly data are summed to get annual totals. Data in all bond categories cover bonds offered for public sale or placed privately, including floating rate notes as well as medium-term floating rate certificates of deposit. For all bank loan categories, the date of signature of contract (where available) is the one used for the breakdown by period, or if not, the date of completion at which the final arrangements as regards the loan are concluded.

International Bonds

An "international" (or "euro") bond issue is one that is placed simultaneously on the market of at least two countries and is denominated in a currency which need not necessarily be that of either, usually through international syndicates of financial institutions of several countries. The data cover bonds offered for public sale or placed privately, including floating rate notes as well as, since 1981, medium-term floating rate certificates of deposit.

Foreign Bonds

Depending on where the bonds are issued, these debt instruments are also known as Bulldog Bonds, Samurai Bonds, Yankee Bonds, etc.[16] A "traditional" foreign issue is one which is placed, generally by a domestic syndicate, on the market of a single country.

The following are defined as foreign issues:

a) issues by governments, government agencies or political subdivisions which are not located in the country on the market of which the issue is made,

b) issues by international organisations,

c) issues by companies not having their registered office in the country concerned or not having been incorporated under the legislation of that country,

d) officially sponsored international enterprises, except when their registered office is in the country concerned,

e) purely financial subsidiaries which have their registered office in the country concerned but whose parent company has its registered office in another country, and which have little or no production capacity in the country concerned.

International Bank Loans

OECD publications also refer to this category as "international medium- and long-term bank loans." The material covers international medium-term bank loans proper, including term loans, project-related loans, revolving lines of credit, medium-term export credits, etc. General reschedulings of commercial bank debt are not included, nor is restructuring of individual credit agreements. However, if new credit is extended to debtors, this element is included, as are refinancings incorporating new lending terms.

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[16] For this report, the foreign bond total includes a small number of issues tabulated by the OECD as "special placement of bonds" and including issues by development institutions placed directly with governments or central banks, and, as of October 1984, issues specially targeted to foreigners. The OECD refers to its foreign bond category as "traditional."

In common with foreign bank loans, international bank loans cover loans with an original maturity of at least one year which have been granted by commercial banks wholly or in part out of Euro-currency funds, i.e. liabilities in foreign currencies of banks, irrespective of whether the counterpart is a resident or a non-resident of the country in question. They include credits that have been widely syndicated and loans by one or, alternatively, a small group of banks ("club loans") that have been publicized, but exclude officially guaranteed loans, even if financed by euro-currency funds. The data exclude loans realized in the form of negotiable instruments such as bonds or notes. Loans granted by international organizations (EIB, the World Bank, etc.) are not included.

Foreign Bank Loans

OECD publications also refer to this category as "foreign medium- and long-term bank loans." The material covers traditional foreign bank credits, i.e., domestic-currency credits with an original maturity of at least one year extended by a bank or a group of banks in a given country to a nonresident borrower. Loans guaranteed by an export credit guarantee agency are excluded.

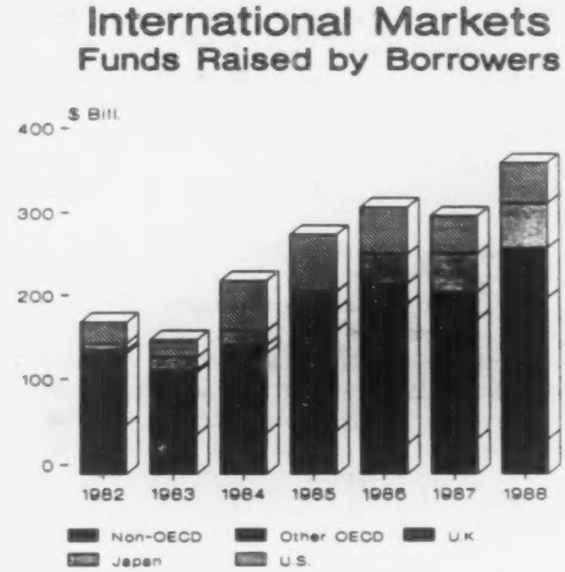
In common with the international bank loans, foreign bank loans cover loans with an original maturity of at least one year which have been granted by commercial banks wholly or in part out of euro-currency funds, i.e. liabilities in foreign currencies of banks, irrespective of whether the counterpart is a resident or a non-resident of the country in question. They include credits that have been widely syndicated and loans by one or, alternatively, a small group of banks ("club loans") that have been publicized, but exclude officially-guaranteed loans, even if financed by euro-currency funds. The data exclude loans realized in the form of negotiable instruments such as bonds or notes. Loans granted by international organizations (the World Bank, etc.) are not included.

Other International Facilities

OECD publications also refer to this category as "other international medium and long-term facilities." The material covers other international medium-term bank facilities such as underwritten facilities to back up the issue of other financial instruments (e.g., commercial paper, short-term euronotes, bond and note issues, certificates of deposits, bankers' acceptances, etc.) as well as precautionary credit lines arranged in the context of take-over bids. Facilities of an altogether guaranteeing nature (advance payments guarantees) and non-underwritten facilities (e.g., euro-commercial paper and medium-term note programs) are excluded.

Funds Raised By Borrowers

The OECD also publishes data on the total sum of funds raised with subtotals for different categories of countries, and with each country identified separately.[17] Based on this published material, the data have been organized according to 1) the three national securities markets previously considered, the United States, the United Kingdom and Japan, 2) other OECD countries (i.e., the OECD excluding the United States, the United Kingdom and Japan), and 3) non-OECD countries. As total borrowing expanded from about $180 billion in 1982 to $370 billion in 1988, the other OECD category retained a fairly constant relative share (45 percent in 1988) of the total. Clearly, the non-OECD countries have dwindled in both relative and absolute importance at the same time that the countries hosting the major financial markets account for an increasing portion of this growing activity. U.S. borrowing has generally kept pace with overall growth of borrowing, while the United Kingdom and Japan have exhibited significant increases in their borrowing.



Source OECD Financial Statistics Monthly

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[17] In the breakdown by issuing countries, companies are deemed to be located in the country where they have their registered office or in the country under the law of which they have been incorporated. However, purely financial subsidiaries are allocated to the country of the parent company, wherever they have their registered office or under whatever law they are incorporated. Financial subsidiaries, which have several parent companies of various nationalities either have been classified under "OECD unattributable," or under "Unattributable to any country."

DOMESTIC NEW ISSUES

Issuers benefit directly only from the *primary* securities markets – the occasion when a security is first offered for sale, and the proceeds of the sale accrue to the issuer. The data used in the charts which follow include proceeds received both by governments and by corporations from their domestic financial markets.[18] For the United States and the United Kingdom, the charted data labeled "government bonds" clearly dominate domestic financial markets, while in Japan corporate use of the new issue markets overshadows government activity.

External finance for corporations is conventionally viewed in two parts, reflecting two very different basic relationships between lender and borrower. When a firm sells shares of stock to raise funds in the equity market, it is selling ownership rights to the company. Holders of common stock usually participate in the election of directors and other corporate governance matters. All external funds which are not equity come from the credit markets, i.e., the money is borrowed. Long-term borrowing is usually effectuated through the sale of bonds or similar securities; bank loans are frequently used for short-term corporate borrowing.

The charts make it very clear that equity financing is not now an important source of corporate funds in any of the three major financial markets.

U.S. New Issues

The coverage presented here for the U.S. markets is more extensive than that for the U.K. and the Japanese markets. Because the data is more readily available, it is possible to look more closely at both gross new issues and net new issues. The section on the U.S. markets indicates that, on a *net* basis, equity funds have been leaving the financial system, and that corporate debt, on a *net* basis, is considerably less robust than it first appears. For the economy as a whole, only the net funds are available to fund corporate projects.

Gross New Issues

The U.S. domestic financial markets are clearly dominated by government borrowing, with other bonds strongly outpacing newly issued corporate shares. There are no official estimates of the size of this market, but most estimates are of similar size, with variations based on the timing of reports, intended coverage, and analogous considerations. Thus, measuring the size of the international capital markets remains an inexact science, with different estimates available from different sources. It may be an exercise in futility to add together a series of inexact measures and then report the results with decimal point accuracy. Nevertheless, CRS has prepared a table, shown below, in an effort to pull together the various *gross* sources of capital available to the U.S. private sector. The table should be read as an indication of trends, not as a precise measure of capital flows.

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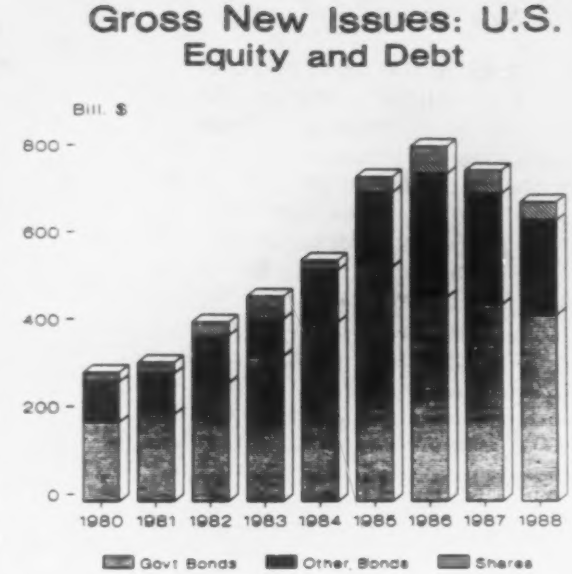
[18] The "government bond" data for each of the three countries was calculated by CRS as the sum of central government bonds and local government bonds (in the United States, State, and local government bonds). Some 1988 data for the United States and Japan were estimated by CRS based on partial OECD reporting and trend extrapolation.



Source OECD Financial Statistics Monthly

TABLE 3. U.S. Private Sector Capital
(billions of dollars)

	International Bonds	Foreign Bonds	Domestic Bonds	Corporate Equity	Total
1982	13.0	1.8	107.9	30.7	153.4
1983	6.1	1.2	85.8	57.5	150.6
1984	21.5	1.5	117.9	22.6	163.5
1985	36.3	3.2	173.2	35.5	248.2
1986	38.6	5.1	285.1	61.9	390.7
1987	19.3	2.3	256.7*	53.4	331.7
1988	16.7	1.1	218.2*	42.3	278.3

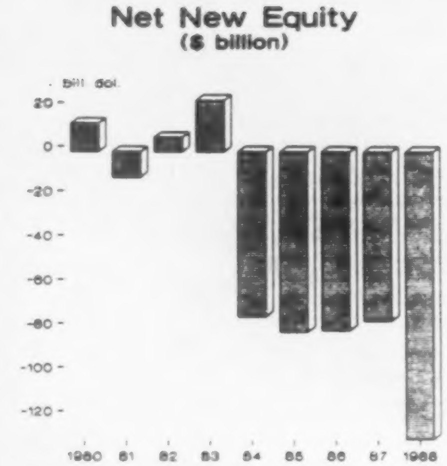
* Estimate by CRS based on partial data.

Source: *OECD Financial Statistics Monthly*, March 1989.

Short-term credit facilities are frequently included in measures of international capital market activity, but are excluded from the above table.

Net New Issues

Even in the worst of years for the stock market, there are always some companies that use the primary market to offer their shares to the public; necessarily, this gross figure will always be positive. The net equity flows for the nine-year period pictured in this chart, however, come to a cumulative total of *minus* $412.5 billion, with the negative 1988 figure (-$130.5 billion) by itself accounting for 32 percent of this negative flow. As inauspicious as the data seem, they are conservative by virtue of their *net* basis, that is, they are offsetting the positive gross new offerings. So it is these positive annual *gross* offerings of new stock shown in a previous chart which are used as a base to calculate the net flows. According to the Federal Reserve Board, the total of both common and preferred newly issued stocks amounted to $61.830 billion in 1986 (plus $6.603 billion in privately placed stock), dropping to $53.548 billion in 1987 (plus $13.157 billion in private placements) and reduced again in 1988 to $42.456 billion (private placement data for 1988 have not been published yet by the Federal Reserve).[19]



Source: Federal Reserve Flow of Funds

The gross offerings of new stock now follow a configuration which marks a considerable departure from traditional financial patterns. Limited partnership offerings, a type of equity security, have grown rapidly in the 1980s, to the point where – on a gross basis – the value of their new offering volume in 1988 dollar outstripped that of conventional common stock offerings. Funding provided to one industry category – financial and real estate – dominates these limited partnership offerings; thus core "smokestack" industries such as manufacturing and utilities are now minor participants in gross new equity offerings.[20] Some limited partnership securities are actively traded while for others there is a relatively illiquid secondary market.[21]

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[19] Table 1.46, *Federal Reserve Bulletin*, April 1989. p. A34. Apparently because the data are more inclusive, estimates by the Federal Reserve are uniformly higher than those published by the Securities and Exchange Commission.

All Federal Reserve flow of funds data, including corporate bond offerings, are published on a net basis; the Federal Reserve also publishes data for gross new corporate bond offerings, and a comparison of these two series is useful for illustrating a massive withdrawal of funds from the bond market in recent years. The data presented in table 4 provide this comparison.

TABLE 4. Newly Issued Corporate Bonds
($ billions)

Year	Gross Issued	Net Issued	Apparent Removals
1983	$ 47.4	$ 25.5	$ 21.9
1984	73.6	66.7	6.9
1985	119.6	96.4	23.2
1986	231.9	111.4	120.5
1987	209.3	99.0	110.3
1988	199.2	97.4	101.8

Source: Col. 1: *Federal Reserve Bulletin*. Table 1.46, various issues. Col. 2: Federal Reserve Statistical Release Z.7 (788). Flow of Funds Summary Statistics, March 8, 1989. Col. 3: Calculated by CRS.

The two basic data series in table 4 may not be directly comparable; nonetheless, they show that starting in 1986, more than half of newly issued corporate bonds have been offset by apparent removals of bond issues from the public markets. Apparent removals could occur for the following reasons: merger related exchange of bonds for stock, maturing bonds, bonds called by the issuer, sinking fund requirements, and debt for equity swaps. The calls and the sinking fund requirements would probably account for most of the adjustment.

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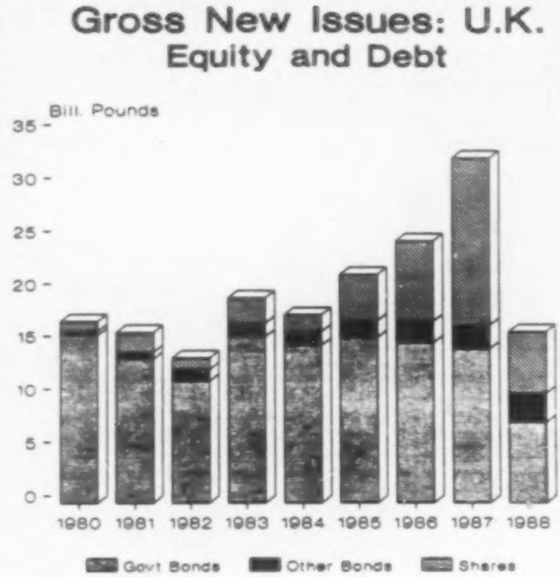
[20] These comments are based on data released by the Securities and Exchange Commission (SEC). For a more thorough treatment of these SEC data, see U.S. Library of Congress. Congressional Research Service. *Patterns in the Financing of U.S. Industry: Gross Proceeds of New Security Offerings*. Report No. 88-616 E, by Kevin F. Winch. Washington, 1988. 54 p.

[21] For the results of a survey of secondary market activity in limited partnership securities, see Betttner, Jill. Partnership Prices, Yields Draw Investors. *Wall Street Journal*, May 1, 1989. p. C1, C12.

U.K. New Issues

The London financial community is still reacting to the extensive deregulation moves known as the "Big Bang." That event, on October 27, 1986, drastically revised the way securities were marketed in the U.K. For example, the Big Bang eliminated minimum commission rates and introduced the Stock Exchange Automated Quotations System (SEAQ), an electronic trading system which abolished trading on the floor of the exchange.[22]



Source OECD Financial Statistics Monthly

Current influences on the U.K. non-government new issue market reflect the continued influence of both public policy decisions and market forces.

Since the early 1980s, an increasing share of UK industrial and commercial companies' funds have come from capital issues on the stock market. In 1987, equity capital accounted for 52% of companies' liabilities compared to 37% in 1981. About an eighth of this increase was a result of money raised from new issues, the rest being an increase in share prices. The relative reduction in the cost of equity versus debt financing as a result of corporation tax changes and the relative buoyancy of the stock market are reasons why companies have used equities to raise funds. Money raised from new and further issues of equity by companies admitted to the Exchange increased from a typical level of £100 million per year in the late 1970s to over £1 billion per year (or £4 to £5 billions per year including privatisations).[23]

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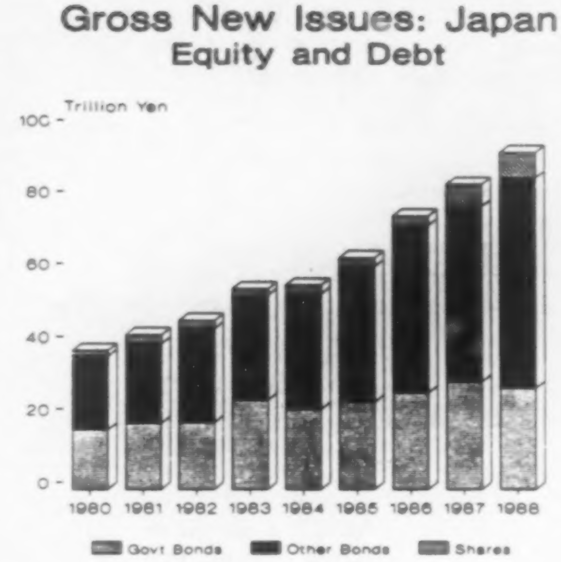
[22] See Miller, Sam Scott. Regulating Financial Services in the United Kingdom—An American Perspective. *Business Lawyer*, v. 44, February 1989. p. 323-365.

[23] The Primary Market. *Quality of Markets Quarterly*, Winter 1988/89. p. 19.

Japanese New Issues

The Japanese financial markets are different than other major financial markets, including U.S. and U.K. The point has been made previously in this report, and it has been made often by other commentators. The most striking characteristic of this chart is the relatively modest participation by government entities in the domestic Japanese markets. As a result, virtually all of the increased capital raised in Japanese markets in the 1980s has gone to the corporate sector. In one respect — the relatively nominal role of new equity issues — the Japanese markets are similar to the U.S. and U.K. markets (excluding the privatization issues in the U.K.).



Source OECD Financial Statistics Monthly

Analysts at the investment banking firm Salomon Brothers estimate that Japanese firms experience an extremely low cost of capital.

> The blended cost of funds for listed firms that issue equity or equity-linked bonds is about 1%. . . .The new issue market has become a powerful source of low-cost capital that permits Japanese firms to support aggressive fixed investment and R&D expenditure, with little concern about the cost of financing. . . .The ability of listed Japanese corporations to raise ¥17 trillion in one year at an average of 1% maintenance cost is a powerful source of net worth and generates a direct addition to the bottom line.[24]

FUTURES MARKETS

While trading in financial futures contracts is a relatively new form of commodity futures trading, it has been around long enough so that it is no longer considered exotic. Although U.S. futures trading for some agricultural commodities dates back to the 1860s, financial futures trading began on October 25, 1975, on the Chicago Board of Trade (CBOT) with a contract based on Government National Mortgage Association (GNMA) mortgage backed pass-through certificates. Since their introduction, the growth and popularity of financial futures has been remarkable.

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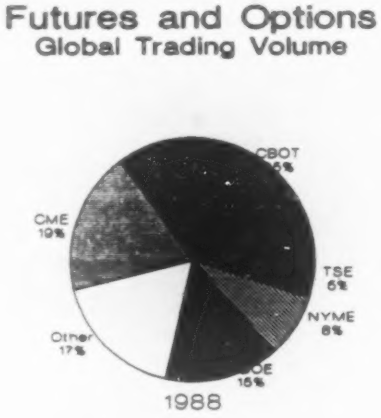
[24] Napier, Ron. *Japanese Liquidity and the Flow of Funds*. Salomon Brother, May 4, 1989. p. 8, 9.

Futures contracts for financial instruments now cover a wide spectrum and allow market participants to act on anticipated changes with regard to interest rates, stock prices, and currency rate changes. There is also active trading in contracts for precious metals, and for a variety of agricultural and mineral products. In North America, there are 15 U.S. futures exchanges and 4 Canadian ones; 13 such exchanges are in Europe, with an additional 9 futures exchanges in the far east and Australasia.[25]

Measuring overall activity in futures markets is difficult on two counts. The first difficulty stems from the diverse nature of the items under contract; the second arises from the use of margins, that is, participants make down payments rather than pay the full contract price. As a matter of convention, market activity is measured by the number of contracts traded; the share of the market by the top ten exchanges is shown in the accompanying chart.[26] The top four exchanges are in the United States, with a concentration in Chicago.



Top ten exchanges: 410 million contracts

Source Corporate Finance

For the securities markets, financial futures (and options) trading may be viewed as an alternative way of participating in the underlying markets. In addition to the growing international trading in equities, there are a number of derivative equity-based products traded domestically which also attract international investors. These products include: stock index futures, options on stock index futures, and stock index options. Unlike stocks, futures and options contracts are not claims of ownership in corporations. They are derivative products whose value is determined by the changes in the prices of standardized portfolios of stocks (i.e., the underlying assets of the contract).

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[25] Dickens, Paul. Global Growth Outruns US Problems. *Corporate Finance; Futures & Options Directory '89*. Supplement, March 1989. p. 1-6.

[26] CBOT = Chicago Board of Trade, CME = Chicago Mercantile Exchange, CBOE = Chicago Board Options Exchange, NYME = New York Mercantile Exchange, TSE = Tokyo Stock Exchange. The "other" category includes the New York Commodity Exchange (Comex), Marche a Terme des Instruments Financiers (Matif), London International Financial Futures Exchange (Liffe), the Coffee, Sugar & Cocoa Exchange of New York, and the Philadelphia Stock Exchange.

A stock index future is a contract which obligates the seller (buyer) to make (take) delivery of the cash equivalent of the contract's value at its expiration date. Examples of such indexes are the Standard and Poor's (S&P) 500, or the Major Market Index of 20 stocks (MMI). S&P futures contracts are traded on the Chicago Mercantile Exchange; the MMI contract is traded on the Chicago Board of Trade.

Stock index futures options are contracts which give their owners the right (not the obligation) to buy or sell (i.e., to place a call or put) an index futures contract on or before its expiration date. For example, the S&P 500 futures option traded on the Chicago Mercantile Exchange is an option to buy or sell a S&P stock index futures contract. The absence of a mandatory fulfillment requirement for an option contract limits the risk of participants to the purchase price of the contract.

Stock index options are contracts that give the purchaser the right (not the obligation) to make cash settlement on or before the expiration date of the stock index contract. The purchaser does not have to exercise the option; he can allow it to expire. The S&P 100 contract traded on the Chicago Board of Options Exchange is an example of a stock index option.

Fund managers like these derivative products because they are an efficient and low cost means of altering their investment strategies in managing their stock portfolios. Reduced costs come from lower commissions and the increased flexibility which can lead to fewer trades. Since their first offering in 1982, these stock index futures and options have been increasingly used by institutional investors, especially pension funds and mutual funds, to manage the exposure and risk of their investment in stocks, and for arbitrage. (Arbitrage is a means of profiting from price spreads that can develop between equities, futures, and options markets by buying in the lowest-price market and selling in the highest-price market.)

Several markets abroad, especially in Japan and Great Britain, are now rapidly expanding their trading in futures and options contracts. Currently, U.S. markets have a competitive edge in this area of trading. Nonetheless, if markets abroad find ways to trade these contracts more efficiently and at lower costs than is currently done in the United States, then some of this trading activity could go off-shore.

INTERNATIONAL SWAP MARKET

The market for swap transactions has been one of the most successful recent innovations in international finance. First introduced in 1982, swaps have proliferated in number and kind: the value of swaps outstanding was estimated to have passed the $1 trillion mark in 1988.[27] Swaps go largely unregulated and are usually invisible on financial balance sheets. The swap market to date has been free of serious problems or major defaults, but some observers express concern about its rapid growth, citing the sheer size of the market and the possible risks to participants.

There are two major types of swaps: interest rate swaps and currency swaps. In an interest rate swap, the participants in effect exchange interest obligations by agreeing to make interest payments to each other through an intermediary, the swap dealer. In this way they are able to lessen their exposure to risk from changing interest rates or to obtain cheaper funds. The parties to a currency swap agree to make payments to each other denominated in different currencies, enabling each to hedge the risk of exchange rate fluctuations.

As an example of how an interest rate swap works, consider a hypothetical American thrift institution. Its assets are fixed rate mortgages, but it must pay its depositors market rates to remain competitive. If interest rates rise, its income will not cover the interest payments it makes to its depositors. Now imagine a European commercial bank that must meet fixed rate debt obligations and whose assets are predominately variable rate loans. This bank will lose income if interest rates *fall*. The two institutions enter into a swap: the U.S. thrift agrees to pay a fixed rate of interest on a specified principal amount to the European bank, which in return agrees to pay a variable rate of interest on the same principal to the U.S. "counterparty." (The principal is "notional" because it is never paid: any principal amount can be specified to meet the needs of the participants.) Each has insured itself against an opposite risk. If interest rates rise, the thrift will still have to pay out more in interest to its depositors, but it will be compensated by the rise in income from the swap. If rates fall, the European bank benefits in the same way.

Another type of swap takes advantage of different interest rate structures in different markets. Suppose that an American firm wishes to borrow money long term at a fixed rate, but its credit rating is so low that the domestic bond market will demand a higher rate than it wishes to pay. A German corporation with the highest possible credit rating wishes to borrow at a floating rate. However, in the German credit market, for whatever reason, the spread between fixed and variable interest rates for borrowers of different creditworthiness is less than in the U.S. market. This gives the U.S. firm a comparative advantage in variable rate borrowing, and opens the way for a swap. The German firm borrows at a fixed rate, the American at a floating rate, and they exchange obligations through a swap: the German firm agrees to pay a variable rate to the American firm, which will pay a fixed rate to the other. The swap enables both parties to obtain a lower interest rate than would have been possible in their respective domestic markets.

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[27] Henderson, Schuyler K. Swap Credit Risks: A Multi-perspective Analysis. *Business Lawyer*, v. 44, February 1989. p. 365.

In principle, currency swaps are no different than interest rate swaps. If the same German firm had issued U.S. dollar-denominated debt, such as Eurobonds, but feared that a rising dollar would increase its real interest costs, it might enter into a currency swap. It would agree to pay a certain amount in D-marks in return for payments in dollars sufficient to meet its interest obligations. This type of swap would provide a hedge against the risk of exchange rate fluctuations.

Major participants in the swaps market include banks, all types of financial institutions, nonfinancial corporations, and governments. The parties to a swap often do not know each other's identities, but make and receive payments through an intermediary. The dominant intermediaries, or swap dealers, are American, European, and Japanese commercial and investment banks. In addition to their role as matchmakers, as brokers bringing together institutions with opposite needs (such as those in the examples above), many swap dealers act as principals in their transactions.

Swaps are not standardized contracts but are tailored to the needs of individual participants. This explains some of their popularity; they are far more flexible than other instruments, such as financial futures contracts, that perform some of the same hedging functions. There exists a wide and growing variety of swap transactions, giving participants an unprecedented ability to take advantage of international differences in credit market conditions and in tax and regulatory structures.

Because of the size and rapid growth of the market, swaps have attracted considerable interest from regulators and financial economists. At present regulatory and accounting standards for swaps are minimal, and participants are under no obligation to make public the terms of transactions. There is a range of opinion as to the risks involved in swaps.[28] Some observers and participants believe that the market functions well in the absence of regulation, maintaining that many swaps serve to reduce risk or resemble a kind of risk-free arbitrage among different credit markets. Others believe that swap participants are exposed to risk in the case of a defaulting counterparty. A default on a swap could leave the opposite firm exposed to precisely the market conditions it tried to avoid at a time when it might be much more expensive to create another hedge. There has not yet been a major court test of the legal force of swap provisions in a bankruptcy case. (The Senate passed legislation in 1988 (S. 2279, 100th Congress) which addressed the issue of bankruptcy of a swap participant.) There is also concern that use of swaps as vehicles for speculation will lead to problems sooner or later,[29] and that swap dealers who enter into transactions as principals may incur substantial risks.

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[28] For a review of this question and related literature see: Wall, Larry D., and John J. Pringle. Interest Rate Swaps: A Review of the Issues. *Federal Reserve Bank of Atlanta Economic Review*, November/December 1988. p. 22.

Given the short history and the rapid development of the swap market, little can be concluded at this time about what its long term impact is likely to be. It is clear, however, that market participants have found swaps to be a very useful tool in financial management, and that swaps have made a significant contribution to the globalization of financial markets.

FOREIGN TRANSACTIONS IN U.S. SECURITIES

The charts on the following pages show the dollar value of foreign transactions in U.S. long-term securities during the 1980s. The data, which are published regularly in the *Treasury Bulletin*, reflect securities transactions by foreigners reported by banks and brokers in the United States. The data cover new issues of securities, trading in outstanding securities, and redemptions of securities. They include trades executed in the United States for the account of foreigners, and transactions executed abroad for the account of reporting institutions and their domestic customers. The value of purchases and sales is shown for 3 groups of securities: 1) U.S. Government long-term bonds (marketable Treasury and Federal Financing Bank bonds and notes, and bonds of government corporations and federally sponsored agencies), 2) other bonds (corporate, State, and municipal bonds), and 3) corporate stock. The value of foreigners' transactions in each of these categories has increased dramatically in recent years, although 1988 saw a decline in the value of transactions in stocks and bonds (other than U.S. Government bonds).

Beginning around 1984, foreigners appear to have become a significant presence in U.S. securities markets. Foreigners' stock transactions in 1988 were equal to about 10 percent of the value of all trading on the New York Stock Exchange. And in 1988, foreign investors were net purchasers of almost $50 billion in long-term U.S. Government bonds.

These data show that British and Japanese investors dominate foreign activity in U.S. securities markets: Japan and the United Kingdom in 1988 accounted for about half of all trading in U.S. stocks by foreigners and an even higher proportion of transactions in debt instruments.

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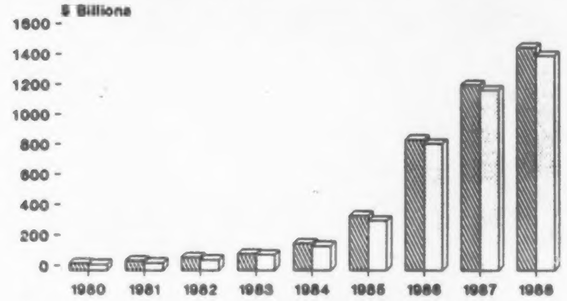
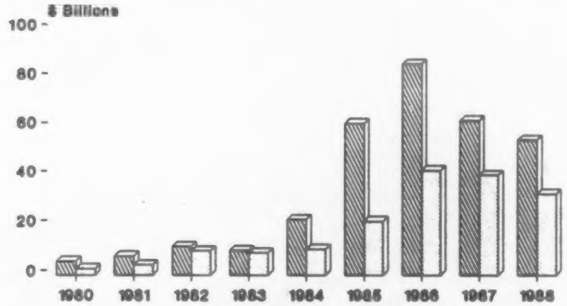
[29] For an example of the perils of the speculative use of swaps, see: A Little Local Difficulty. *Economist*, v. 311, March 18, 1989. p. 84.

Foreign Transactions in U.S. Securities, 1980-1988: All Countries

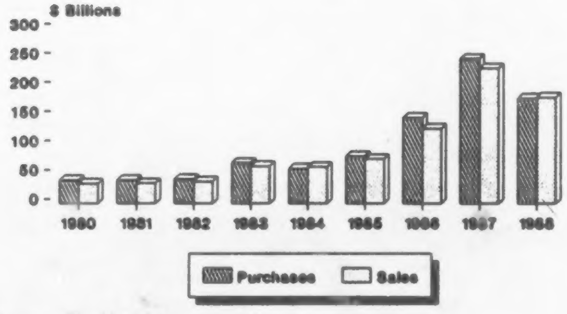
US Government Bonds



Other Bonds



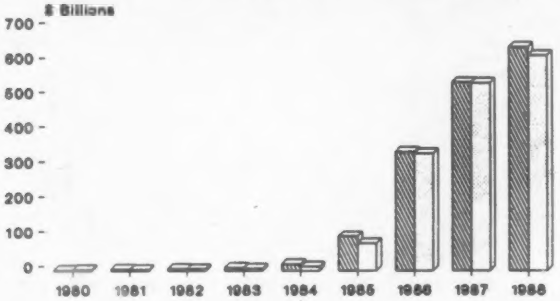
Stocks



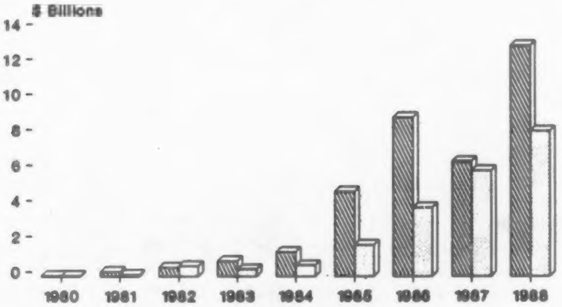
Source: Treasury Bulletin

Foreign Transactions in U.S. Securities, 1980-1988: Japan

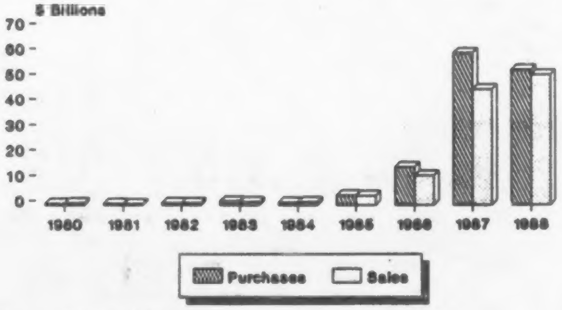
US Government Bonds



Other Bonds



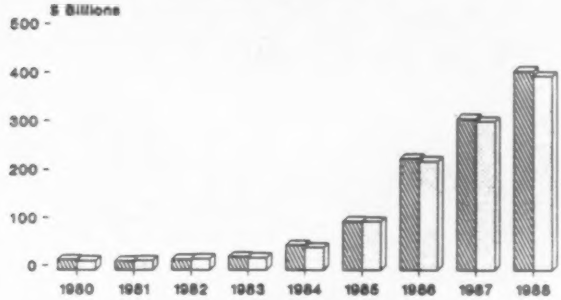
Stocks



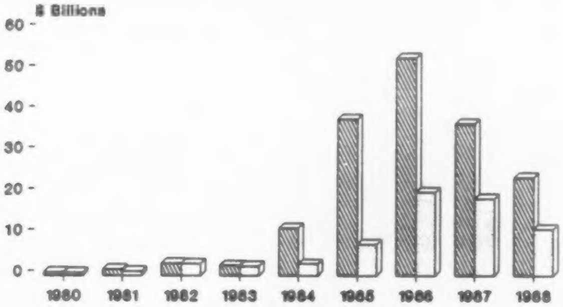
Source: Treasury Bulletin

Foreign Transactions in U.S. Securities, 1980-1988: United Kingdom

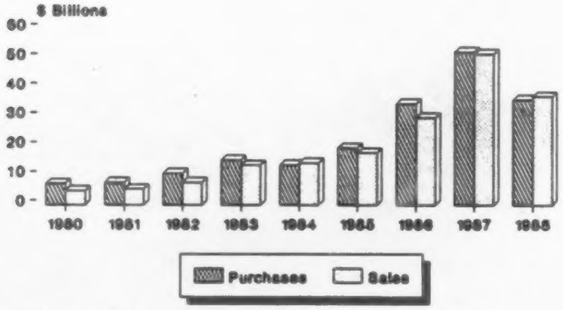
US Government Bonds



Other Bonds



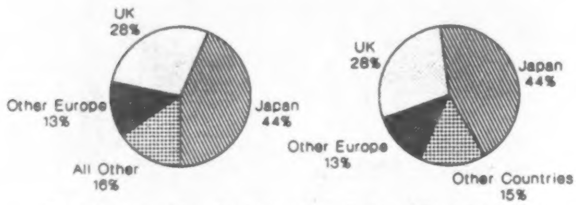
Stocks



Source: Treasury Bulletin

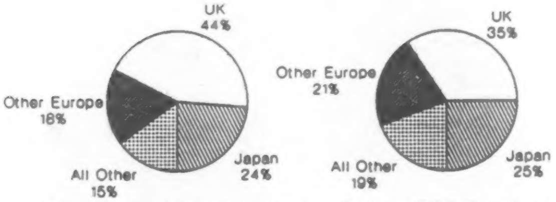
Foreign Transactions in U.S. Securities, 1988

US Government Bonds



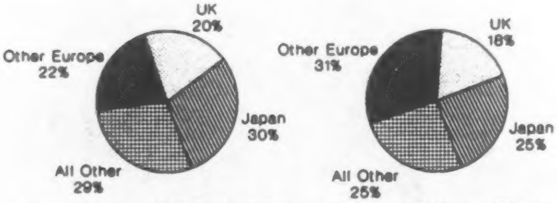
Purchases ($1.47 trillion) Sales ($1.42 trillion)

Other Bonds



Purchases ($54.8 billion) Sales ($32.7 billion)

Stocks



Purchases ($180.0 billion) Sales ($182.0 billion)

Source: Treasury Bulletin

APPENDIX A: SUPPLEMENTARY DATA

TABLE A-1. Top Global Underwriters of Debt and Equity

	First Quarter 1989		First Quarter 1988		
Manager	Amount (in millions)	Market Share	Amount (in millions)	Rank	Market Share
Merrill Lynch Capital Markets	$15,715.6	11.3%	$13,096.1	1	10.8%
First Boston/CSFB	12,977.2	9.4	11,075.2	2	9.2
Goldman, Sachs	11,521.4	8.3	3,578.1	4	7.1
Nomura Securities	11,251.5	8.1	4,246.6	8	3.5
Salomon Brothers	6,984.1	5.0	10,468.7	3	8.7
Morgan Stanley	6,388.2	4.6	8,131.8	5	6.7
Daiwa Securities	6,357.8	4.6	3,614.1	10	3.0
Nikko Securities	5,873.7	4.2	1,775.6	17	1.5
Shearson Lehman Hutton	5,614.5	4.0	5,641.6	6	4.7
Yamaichi Securities Company	3,806.3	2.7	1,543.5	22	1.3
Union Bank of Switzerland	3,631.4	2.6	3,138.6	11	2.6
Drexel Burnham Lambert	3,573.0	2.6	3,642.7	9	3.0
Bear, Stearns	3,342.8	2.4	3,056.4	12	2.5
Morgan Guaranty Trust Company	3,185.4	2.3	1,713.1	18	1.4
Deutsche Bank AG	2,915.8	2.1	4,706.6	7	3.9
Subtotals	$103,138.8	74.4%	$84,428.7		69.9%
Industry Totals	$138,675.5	100.0%	$120,714.2		100.0%

Source: Securities Data Company as reported in the *Wall Street Journal*, April 3, 1989, p. C12.

TABLE A-2. Top Underwriters of U.S. Debt and Equity

	First Quarter 1989		First Quarter 1988		
Manager	Amount (in millions)	Market Share	Amount (in millions)	Rank	Market Share
Merrill Lynch Capital Markets	$13,738.4	19.7%	$11,267.9	1	16.4%
Goldman, Sachs	10,113.9	14.5	8,236.1	3	12.0
First Boston	9,934.4	14.2	7,753.0	4	11.3
Salomon Brothers	6,229.1	8.9	9,794.4	2	14.3
Shearson Lehman Hutton	5,269.0	7.5	5,215.0	6	7.6
Morgan Stanley	4,671.6	6.7	7,222.3	5	10.5
Drexel Burnham Lambert	3,573.0	5.1	3,642.7	7	5.3
Bear, Stearns	3,342.8	4.8	3,056.4	8	4.5
Prudential Bache Capital Funding	2,735.0	3.9	2,717.5	9	4.0
Kidder, Peabody	2,282.9	3.3	1,387.7	13	2.0
Union Bank of Switzerland	1,443.0	2.1	-	-	-
Dean Witter Capital Markets	1,062.0	1.5	269.8	16	0.4
Paine Weber	1,016.1	1.5	1,706.8	12	2.5
L.F. Rothschild	744.0	1.1	20.2	31	0.0
Citicorp	488.8	0.7	142.1	19	0.2
Subtotals	$66,664.0	95.4%	$62,431.6		91.0%
Industry Totals	$69,888.3	100.0%	$68,633.5		100.0%

Source: Securities Data Company as reported in the *Wall Street Journal*, April 3, 1989, p. C1.

TABLE A-3. Top International Underwriters
(Non-U.S. Debt and Equity, All Issues; Full Credit to Book Manager)

	First Quarter		
	1989		1988
Manager	Amount (in millions)	% of Market	% of Market
Nomura Securities	$11,173.4	16.2%	8.2%
Daiwa Securities	6,357.8	9.2	6.9
Nikko Securities	5,873.7	8.5	3.4
Yamaichi Securities Company	3,806.3	5.5	3.0
Credit Suisse First Boston	3,042.8	4.4	6.4
Deutsche Bank AG	2,915.8	4.2	9.0
Morgan Guaranty Trust Company	2,885.5	4.2	3.3
Bankers Trust	2,382.3	3.5	2.5
Union Bank of Switzerland	2,188.4	3.2	6.0
Merrill Lynch Capital Markets	1,977.2	2.9	3.5
Subtotals	$42,603.2	61.9%	52.2%
Industry Totals	$68,787.2	100.0%	100.0%

Source: Securities Data Company as reported in the *Wall Street Journal*, April 3, 1989, p. C13.

TABLE A-4. Top 40 Commercial Banks, 1987
($ in millions)

Rank	Bank	Country	Assets (U.S.$)	Pre-tax Profits (U.S. $)
1	Dai-Ichi Kangyo Bank	Japan	$270,782	$1,360
2	Sumitomo Bank	Japan	250,568	858
3	Fuji Bank	Japan	244,057	1,437
4	Mitsubishi Bank	Japan	227,522	1,336
5	Sanwa Bank	Japan	218,197	1,219
6	Industrial Bank of Japan	Japan	215,605	781
7	Credit Agricole	France	214,382	852
8	Citicorp	U.S.A.	198,388	-240
9	Norinchukin Bank	Japan	186,534	244
10	Banque Nationale de Paris	France	182,675	852
11	Deutsche Bank	Germany	168,904	1,030
12	Credit Lyonnais	France	168,344	919
13	Mitsubishi Trust & Banking	Japan	166,085	1,110
14	Barclays	U.K.	164,301	634
15	National Westminster Bank	U.K.	162,880	1,318
16	Tokai Bank	Japan	161,762	694
17	Sumitomo Trust & Banking	Japan	154,435	1,047
18	Mitsui Bank	Japan	154,132	928
19	Societe Generale	France	144,951	701
20	Long-Term Credit Bank of Japan	Japan	138,950	664
21	Taiyo Kobe Bank	Japan	138,654	581
22	Bank of Tokyo	Japan	136,556	676
23	Mitsui Trust & Banking	Japan	130,529	731
24	Dresdner Bank	Germany	130,463	622
25	Yasuda Trust & Banking	Japan	128,866	680
26	Daiwa Bank	Japan	126,269	473
27	Union Bank of Switzerland	Switzerland	125,521	851
28	Compagnie Financiere de Paribas	France	122,275	894
29	Swiss Bank Corporation	Switzerland	114,390	722
30	Toyo Trust & Banking	Japan	109,204	578
31	HongkongBank	Hong Kong	106,156	N.A.
32	Commerzbank	Germany	101,236	472
33	Chase Manhattan Corporation	U.S.A.	99,133	-718
34	Westdeutsche Landesbank Girozentrale	Germany	96,147	178
35	Banca Nazionale del Lavoro	Italy	96,072	198
36	Bayerische Vereinsbank	Germany	94,541	396
37	Nippon Credit Bank	Japan	92,952	336
38	BankAmerica Corporation	U.S.A.	90,896	-869
39	Midland Bank	U.K.	90,679	-945
40	Kyowa Bank	Japan	88,350	489

Source: *The Banker*. July 1988.

APPENDIX B: GLOSSARY

Bulldog Bonds – foreign bonds issued in the United Kingdom (see also ***Foreign Bonds***).

Currency Swaps – agreements between two counterparties to exchange specific amounts of one currency for another and to re-exchange the currencies at a specific time in the future. The swaps are designed to occur at a predetermined rate of exchange, usually based on the spot rate of the two currencies as of the beginning of the swap period (see also ***Interest Rate Swaps***).

Dual Currency Bonds – long-term securities denominated in two currencies. The most common types have been bonds with initial and interim coupon payments in a non-dollar currency such as Swiss francs or yen, and a fixed final principal payment in United States dollars (see also ***Foreign Currency Bond***).

Equity Related Bonds – bonds that have both a debt and an equity component, e.g., convertible bonds and bonds with equity warrants.

Eurobond – debt security issued multinationally through an international syndicate of banks or securities firms in a currency other than that of the country in which the bond is issued. The all-inclusive term has several derivatives and variations, such as Eurodollar bond, Euroyen bond, Euro-DM bond, etc., that indicate the currency in which the offering is denominated; and Asiadollar bond, etc., which indicates the primary geographic area of the offering (see also ***Foreign Bond*** and ***International Bond***).

Eurocommercial Paper – short-term, unsecured debt taking the form of promissory notes and issued in the same manner as Eurobonds.

Eurocredits (see ***Syndicated Loans***)

Eurocurrency Market – the market for deposit liabilities, denominated in a currency other than that of the country of the bank in which the deposit is made.

Eurodollar Securities (see ***Eurobond***)

Euroequity – Euroequities include common and preferred stocks distributed to investors in one or several markets outside the issuer's domestic market by a syndicate of international securities firms and banks.

Euromarket – the generic, all-inclusive term refers to all types of markets other than strictly domestic and foreign markets (see ***Eurobond,***

Eurocommercial paper, Eurocurrency market, Euroequity, and ***Euronotes***).

Euronotes – the term refers to short-term paper issued in the Euromarket similar in most respects to commercial paper except that it is issued pursuant to a facility of medium-term duration. A Euronote facility provides a guarantee to the issuer for placement of its short-term paper for the period of its duration.

Euroyen Securities (see ***Eurobond***).

Floating Rate Notes – notes (usually unsecured) paying interest at rates adjusted from time to time to correspond to the yield on a selected money market indicator, such as Treasury bills or ***LIBOR***.

Foreign Currency Bonds – bonds whose proceeds are payable in a currency other than the domestic currency of the issuer (see also ***Dual Currency Bond***).

Foreign Bond – debt security issued in a country other than that of the issuer, sold through a syndicate of banks or securities firms located primarily in the country of distribution, and denominated in the currency of that country (see also ***Eurobond; International Bond***).

Grey Market – in the Eurobond context, the grey market is similar to a "when-issued" market. This grey market occurs when members of the selling group and underwriters supply an issue at discount rates prior to the actual offering date. Such a market would be unlawful in the United States. The term also refers to portions of certain domestic markets that are relatively less strictly regulated than the major markets of those countries, or those in which unconventional securities are sold.

Interest Rate Swaps – agreements between two counterparties to exchange interest payment flows of differing character arising from an underlying notional principal amount. The three main types are coupon swaps (fixed rate to floating rate in the same currency), basis swaps (one floating rate index to another floating rate index in the same currency), and cross-currency interest rate swaps (fixed rate in one currency to floating rate in another) (see also ***Currency Swaps***).

International Bond – debt security that is issued originally outside the country of the borrower. These usually take the form of Eurobonds or foreign bonds (see also ***Eurobond, Foreign Bond***).

International Capital Markets – one of the two subsets of the international financial markets. The term refers to all securities issued in the Euromarket or in a foreign market and that have a duration of over one year.

International Equity Market (see ***Euroequity***)

International Financial Markets – an all-encompassing term which refers to all international or multinational markets for short-, medium, and long-term securities and loans, forward and swap contracts. financial futures and foreign currencies. Those portions of the international financial markets dealing with securities are divided into two subsets depending on the maturity of the instrument involved (see also ***International Capital Markets*** and ***International Money Markets***).

International Money Markets – one of the two subsets of the international financial markets. The term refers to all securities issued either in the Euromarket or in a foreign market and that have a duration of one year or less.

LIBOR – London Interbank Offered Rate. This is the deposit rate offered for interbank loans within London. Variations on the term include LIBID, or the London Interbank Bid Rate which is the interest rate at which bids for interbank loans are made. The midpoint of the spread between LIBOR and LIBID is commonly referred to as LIMID.

Merchant Banks – banks that engage in a combination of investment banking and commercial (but not usually retail) banking functions. While prominent in Europe, for legal and historic reasons they are generally not found in the United States.

Netting – the process of offsetting expected deliveries of securities against expected receipts of the same securities. United States registered clearing agencies provide this service to their participants and generate for each participant one net settlement obligation per securities issue per day, rather than multiple delivery and receipt obligations in the same security.

Note Issuance Facilities (see ***Euronotes***)

Revolving Underwriting Facilities (see ***Euronotes***)

Samurai Bonds – foreign bonds issued in Japan (see also ***Foreign Bond***).

Syndicated Loans – bank credits extended by a group of banks in a given country or in different countries, often to nonresident borrowers.

Yankee Securities – foreign bonds issued in the United States (see also ***Foreign Bond***).

Selected by CRS from a glossary in: U.S. Securities and Exchange Commission. *Internationalization of the Securities Markets*. Washington, The Commission, 1987. p. G-1 to G-7.

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